RECENT CASES

ADMINISTRATIVE PROCEDURE—SECTION 5(c) OF APA PROHIBITS AGENCY PROSECUTOR FROM ACTING AS SUBORDINATE OF REVIEWING OFFICER IN POST OFFICE FRAUD CASES

The Post Office Department, finding that plaintiff distributor made misrepresentations in advertising its reducing tablets, issued a fraud order authorizing the local postmaster to return all mail addressed to it to the sender, with the word "fraudulent" stamped on the outside. In an action for an injunction against the local postmaster, the district court upheld the order on the ground that the misrepresentations were in fact made. The court of appeals assumed that the district court's decision was right on the merits, but reversed and entered summary judgment for plaintiff, holding, in the alternative,[1] that the Post Office Department's procedure for determining the question of fraud violated the separation of functions provisions of the Administrative Procedure Act.[2] *Columbia Research Corp. v. Schaffer,* 256 F.2d 677 (2d Cir. 1958).[3]

Since 1872 the Postmaster General has been authorized by Congress to withhold incoming mail from,[4] and forbid the payment of postal money orders to,[5] any person or company using the mails to obtain money fraudulently. The constitutionality of these statutes was early upheld by the Supreme Court.[6] The statutes give no indication, however, as to the procedure to be followed by the Postmaster General in determining whether mail is fraudulent. When hearings were held as part of the procedure, both prosecutive and adjudicative functions were performed either by the same person or by two closely related persons.[7] This practice was subjected to

1. The other ground for reversal was the failure of the Department to publish the relationship of the Assistant and the General Counsel as a regulation, as required by § 3(a) of the Administrative Procedure Act, 60 Stat. 238 (1946), 5 U.S.C. § 1002(a) (1952) (hereinafter cited as APA). "However, if, contrary to what appears to us its very probable purpose, the section does not forbid the powers of the prosecutor and the judge to interpenetrate . . . , nevertheless, we think that § 1002(a) [requires us to] hold the order at bar invalid . . . ." Instant case at 679-80.

2. 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952). See text accompanying note 13 *infra.*

3. On rehearing, the court withdrew its judgment and decided that the action must be held abated due to plaintiff's noncompliance with FED. R. CIV. P. 9 by failure to file a timely motion for substitution of a new defendant since the resignation of Postmaster of the City of New York Schaffer. Instant case at 680-81. See Vibra Brush Corp. v. Schaffer, 256 F.2d 681 (2d Cir. 1958).

4. 28 Stat. 964 (1895), 39 U.S.C. § 259 (1952).

5. 26 Stat. 466 (1890), 39 U.S.C. § 732 (1952).

6. *Ex parte* Jackson, 96 U.S. 727 (1877).

7. For an affirmance of this procedure, see Plapao Labs., Inc. v. Farley, 92 F.2d 228, 229 (D.C. Cir.), *cert. denied,* 302 U.S. 732 (1937). For the history of the use and denial of hearings by the Post Office Department, see Note, 31 IND. L.J. 257, 258-59 n.9 (1956).

severe criticism: "without doubt the most acute problem of our administrative system is created by the so-called combination of prosecuting and adjudicating functions within one agency," [8] and one of the "worst combinations of prosecuting and judging in the federal administrative process occur[s] in fraud-order cases in the Post Office Department . . . ." [9] Some writers [10] and officials,[11] in criticizing agency practices generally, went so far as to recommend a complete separation of the judicial function from the administrative agency. Others [12] proposed only varying degrees of insulation of the adjudicative division within each administrative agency. The objections to the combination of functions in the same or related persons resulted, in 1946, in section 5(c) of the APA, which provides, *inter alia,* that "no officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review . . . ." [13] The manifest purpose of section 5(c), of which the above language is a part, was to effect the separation of prosecuting and adjudicative functions, in order to promote fairness to the parties and to stimulate public confidence in administrative bodies.[14] With several exceptions, the most important of which is the exemption from its operation of the members of the body comprising the agency,[15] it applies to every administrative adjudication in which a hearing

8. Jaffe, *The American Administrative Procedure Act,* 1956 PUB. L. 218, 225.

9. Davis, *Separation of Functions in Administrative Agencies,* 61 HARV. L. REV. 389 (1948).

10. "One wonders, indeed, if the individual can ever be given adequate protection, human nature being what it is, when the prosecuting and adjudicatory functions are still subject to the control of the same agency heads." VANDERBILT, THE DOCTRINE OF THE SEPARATION OF POWERS AND ITS PRESENT DAY SIGNIFICANCE 93 (1953).

11. Minority Opinion of the Attorney General's Committee on Administrative Procedure, *Administrative Procedure in Government Agencies,* S. Doc. No. 8, 77th Cong., 1st Sess. 203-09 (1941).

12. Among these were the Attorney General's Committee on Administrative Procedure, *Administrative Procedure in Government Agencies,* S. Doc. No. 8, 77th Cong., 1st Sess. 56 (1941) (hereinafter cited as *Attorney General's Committee Report*); REPORT OF THE PRESIDENT'S COMMITTEE ON ADMINISTRATIVE MANAGEMENT 36-37 (1937); and both the Senate and House committees reporting on the bill which became the APA, Senate Comm. on the Judiciary, *Administrative Procedure Act, Legislative History, 1944-1946,* S. Doc. No. 248, 79th Cong., 2d Sess. 220, 237 (1946) (hereinafter cited as *APA, Legislative History*).

13. 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952).

14. Scanlan, *Separation of Functions in the Administrative Process,* 15 GEO. WASH. L. REV. 63, 84-85 (1946). The gravity of a fraud-order is readily seen when one considers the many businesses whose entire operations are based on mail orders. The denial of incoming mail to such businesses is tantamount to putting them out of business. Even though the business is not completely dependent on the mails, potential damage in the loss of public good will, due to the adverse publicity, with the resulting decline in sales, is a serious matter. These factors come to bear even if the court of appeals overturns an adverse Department finding, because of the time involved and the unavoidable connotations of publicity.

15. "This subsection shall not . . . be applicable in any manner to the agency or any member or members of the body comprising the agency." 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952). In addition to the exemption of the agency itself, the subsection is also made inapplicable to "applications for initial licenses or to proceedings

is required by statute [16] or in which a hearing has been required by the Supreme Court in order to save the statute from constitutional invalidity.[17] The Post Office Department originally denied that the APA applied to it,[18] but later confessed error [19] and therewith instituted the system followed at the time of the instant case. Under that procedure the Assistant General Counsel of the Fraud Division, one of six operating divisions of the Office of the General Counsel,[20] instituted proceedings by filing a complaint in the Department when he had reason to believe that the mails were being used for a fraudulent purpose.[21] The chief hearing examiner then issued a notice to the party charged [22] and appointed an impartial hearing examiner qualified under the APA [23] who rendered an initial decision and filed his findings and conclusions.[24] Either party could then appeal to the General Counsel, who was "duly authorized to render the Departmental decision for the Postmaster General . . . ." [25] The issue presented by the instant case, the first involving the application of section 5(c) to the Post Office Department,[26] is whether the separation of functions under the Post Office pro-

involving the validity or application of rates, facilities, or practices of public utilities or carriers . . . ." *Ibid.* It has also been held inapplicable to administrative rule-making even when sharply contested issues of fact are involved, and even when such rule-making has immediate and grave economic import to the party concerned. Willapoint Oysters, Inc. v. Ewing, 174 F.2d 676, 692-93 (9th Cir.), *cert. denied,* 338 U.S. 860 (1949). There are several other minor exceptions set forth in § 5 of the act.

16. 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952). Noncompliance may be waived by the party concerned by lack of timely objection if such nonaction is voluntary and without coercion. Democrat Printing Co. v. FCC, 202 F.2d 298, 305 (D.C. Cir. 1952).

17. Wong Yang Sung v. McGrath, 339 U.S. 33 (1950).

18. Since the postal statutes did not expressly require a hearing, the Department contended that its proceedings were not subject to the APA. This position was affirmed in Bersoff v. Donaldson, 174 F.2d 494 (D.C. Cir. 1949). Subsequent Supreme Court decisions on the Immigration Service, Wong Yang Sung v. McGrath, 339 U.S. 33 (1950), and the Interstate Commerce Commission, Riss & Co. v. United States, 341 U.S. 907 (1951), *reversing per curiam* 96 F. Supp. 452 (W.D. Mo. 1950), destroyed the foundation of this argument. For the history of the APA and the Post Office Department, see Cutler, *The Post Office Department and the Administrative Procedure Act,* 47 NW. U.L. REV. 72, 76-78 (1952).

19. See Cates v. Haderlein, 342 U.S. 804, *reversing per curiam* 189 F.2d 369 (7th Cir. 1951).

20. Letter From Herbert B. Warburton, General Counsel, Post Office Department, to the *University of Pennsylvania Law Review,* Dec. 9, 1958, on file in Biddle Law Library, University of Pennsylvania.

21. 39 C.F.R. § 201.4 (1955). Assistant General Counsel had been substituted for Assistant Solicitor and General Counsel had been substituted for Solicitor, but the procedure remained the same. Instant case at 679. Most of the cases which reach the fraud division come from postal inspectors. Occasionally, public complaints are the source. Letter From Herbert B. Warburton, *supra* note 20.

22. 39 C.F.R. § 201.5 (1955).

23. 39 C.F.R. § 201.14 (1955).

24. 39 C.F.R. § 201.23 (1955).

25. 39 C.F.R. § 201.24(h) (1955).

26. *But see* Pinkus v. Reilly, 157 F. Supp. 548, 552 (D.N.J. 1957), which seriously questioned the propriety of the Department's procedure but found it unnecessary to pursue the point. A procedure of the Social Security Administration in which the agency referee acted as both advocate and judge has been held to be noncomplying since such a procedure is precisely that which the APA forbids. Wilson v. Folsom, 151 F. Supp. 195 (D.N.D. 1957).

cedure described above is sufficiently complete to comply with section 5(c) of the APA.

The objection to this procedure centers around the fact that the Assistant General Counsel, who acts as prosecutor, is a subordinate of the General Counsel, who acts as reviewing judge. Although the court was able to dispose of the case by finding that there was no published regulation, as required by section 3(a) of the APA, describing what authority the General Counsel has over the Assistant General Counsel,[27] it expressed great doubt that any regulation could be so drafted as to avoid the "combination" objection if the Assistant remains a subordinate of the General Counsel.[28] Whether or not the General Counsel directly supervises prosecutions, the possibility of prejudice is present. Initially, it may be observed that the General Counsel is, as a practical matter, ultimately responsible for Department prosecutions,[29] and thus it is to be expected that in the performance of his review functions his frame of mind may result in unconscious prejudice against alleged violators. Moreover, in addition to passing on the merits of cases prosecuted by the Assistant, the General Counsel both selects the Assistant and is responsible for his future promotions.[30] These facts may lead the Assistant, even though unconsciously, to select some cases that cater to the prejudices of his superior that otherwise might never have been prosecuted and, on the other hand, to eliminate other cases because he feels that his superior would not favor them although the Assistant himself feels certain that they involve violations that should be prosecuted.[31] The General Counsel thus is in a position to select, although indirectly, the cases to be prosecuted. Similarly, the desire to please his superior may affect the Assistant's presentation of the case. Finally, because of the fact that the General Counsel has himself selected the Assistant, he may be disposed to rely to some extent on the Assistant's judgment rather than solely upon the record.

Admittedly, most of the objections to former Post Office procedures have been eliminated by the utilization of independent hearing examiners.[32]

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27. See note 1 *supra*.

28. Instant case at 680. In reference to Glanzman v. Schaffer, 143 F. Supp. 243 (S.D.N.Y. 1956), *aff'd*, 252 F.2d 333 (2d Cir.), *vacated*, 357 U.S. 347 (1958), which sustained the Post Office procedure, the court said, "[I]t did not . . . give any reasons for this conclusion, and neither in the notice of appeal nor in the briefs on appeal was the question raised or discussed." Instant case at 680.

29. Letter From Herbert B. Warburton, *supra* note 20.

30. *Ibid.*

31. This danger was pointed out by the instant court: "[I]t appears to us reasonable to suppose that the prosecutor will be disposed to select such cases as he believes will meet with his superior's approval, and that his discretion may be exercised otherwise than if each was responsible to the Postmaster only by a separate chain of authority." Instant case at 679. The court also states that if the procedure in the instant case were reversed, *i.e.*, if the General Counsel prosecuted and the Assistant made the final decision, it would plainly be contrary to the purpose of the subsection because "the subordinate would then be passing upon the success of what his superior had undertaken." *Ibid.*

32. See text accompanying note 23 *supra*.

Moreover, since it has been noted that the findings at the initial hearings are generally "rubber-stamped" by the reviewing authorities in the Post Office Department,[33] it might be urged that there is little need for concern about the connection between the prosecutor and the official who makes the final agency decision. However, much doubt has been cast on the independence of the hearing examiner in actual practice.[34] Nor is it proper to justify a close relationship between prosecutor and reviewing authority on the basis of the latter's failure to perform fully the independent reviewing function assigned him. In any event, the foregoing arguments at best can be taken to mean only that whatever danger remains is slight. Elimination of the remaining danger, however, is possible with relatively slight cost to the agency here involved. This has in fact been accomplished, subsequent to the time at which the instant case arose, by establishing in the Office of the Postmaster General an independent judicial officer to whom appeals from the decisions of the hearing examiners are taken.[35] This judicial officer is appointed by the Postmaster General and is subject to civil service.[36] Far from impeding the administrative process, the handling of fraud and obscenity cases has apparently been accelerated by the institution of this change.[37] Balancing the possibility of prejudice to the individual against the cost to the agency in the instant case, the removal of even the relatively remote connection between prosecutor and judge here present seems desirable, and an agency faced with any situation involving a similar balance should of its own accord, as did the Post Office Department, take whatever steps are necessary to remove the possibility of influence.

Whether the APA requires that the Post Office take such steps is a more difficult question. The only language susceptible of interpretation as prohibiting the superior/subordinate relationship between General Counsel and Assistant is that clause which provides that "no officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review . . . ."[38] Whether this clause can be so interpreted is dependent upon whether or not the General Counsel can legitimately be viewed as engaging in prosecuting functions. In the sense that he is officially in charge of departmental prosecutions, he does so engage. An examination of the legislative history of the clause, however, leads to the conclusion that it was

33. 100 U. PA. L. REV. 261, 262 n.11 (1951). See also Note, 66 HARV. L. REV. 1065, 1067 (1953) ("more and more weight has been given the trial examiner's findings on the assumption that he has become independent of agency control").

34. Davis, *supra* note 9, at 394-95; Note, 66 HARV. L. REV. 1065, 1075 (1953).

35. 23 Fed. Reg. 2817 (1958). Apparently this judicial officer has on occasion been utilized in the role of hearing examiner. Such utilization has, however, been held to violate the APA. Borg-Johnson Electronics, Inc. v. Christenberry, 27 U.S.L. WEEK 2360 (S.D.N.Y. Jan. 19, 1959).

36. Letter From Herbert B. Warburton, *supra* note 20.

37. *Ibid.*

38. 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952).

directed toward a different evil.[39] The basic purpose of the quoted clause was to remove from the decision the influence of the prosecutor, who because of his role as investigator is likely to base a decision upon facts and information discovered *ex parte,* not subject to cross-examination and rebuttal in open hearing, and because of his role as advocate cannot bring to the decision an unbiased state of mind.[40] The influence sought to be removed was that of the prosecutor on the judge; there is no indication that the provision was designed to remove the influence of the judge on the prosecutor. Moreover, the General Counsel, in the average case at least, does not acquire those prejudices characteristic of one actively engaged in prosecuting.[41] Also relevant is the limitation of the prohibition to persons engaging in "that [case] or a factually related case," [42] which suggests that something more than indirect engagement in the case under consideration is required in order to render the prohibition operative. The question arises, however, whether the connection present in the instant case is of the nature of the practices intended to be proscribed by the act, and thus violative of the policy embodied therein. An affirmative answer to this question may provide justification for interpreting the above clause to prohibit the connection. In making this inquiry, it may be observed initially that the basic policy underlying the revision of adjudicative procedures in governmental agencies was the promotion and insurance of fairness to the parties.[43] At the same time, Congress sought to preserve the efficiency inherent in the administrative process by permitting the agencies to retain the requisite flexibility in designing procedures fitted to their particular needs.[44] On a narrower plane, several aspects of the legislative history of the act bear upon the question of the permissibility of the superior/subordinate relationship. The history of the clause considered above is again relevant as indicative of the dangers of prosecutive bias with which the drafters were concerned. Of perhaps greater importance is the history of the clause exempting the agency, or members of the body comprising the agency, from the operation of section 5(c),[45] since it is through the deliberations upon this exemption that the views of the drafters on the existence and permissibility of bias at the review stage are best revealed. The justification for granting the agency exemption—even though by so doing the combination of the investigative, prosecutive, and adjudicative functions in a single person was made permissible—was twofold. On the one hand, the danger

39. For a discussion of the Post Office Department's procedures, but concerning only the function of the hearing officer and of the scope of judicial review, see *Hearings on S. 674, S. 675, and S. 918 Before a Subcommittee of the Senate Committee on the Judiciary,* 77th Cong., 1st Sess. 51-69 (1941).

40. *Attorney General's Committee Report; APA, Legislative History* 24-25, 203.

41. *Compare* text accompanying notes 29-31 *supra with* text accompanying note 40 *supra.*

42. 60 Stat. 239 (1946), 5 U.S.C. § 1004(c) (1952).

43. Scanlan, *supra* note 14.

44. *Attorney General's Committee Report* 214; *APA, Legislative History* 250.

45. See text accompanying note 15 *supra.*

of prejudice was viewed as relatively slight; "the sheer volume of work does not permit the agency heads to participate actively in developing one side . . . but requires that they reserve themselves for the task of deciding questions presented to them by others." [46] The possibility of some bias admittedly remained. There appears, however, to have been little concern about the potential dangers of the superior/subordinate relationship.[47] On the other hand, the "disadvantages of sheer multiplication of separate governmental organizations" [48] together with the resulting lack of consistency of action, uncertainty, and breakdown of responsibility, were considered too great to justify or require complete separation.[49] One final aspect of the history is the fact that it was contemplated that in the Post Office and other agencies headed by a single individual the review function would, and should, be delegated.[50] Added to this is the indication that the complete separation of prosecutive and reviewing functions presented, in the drafter's view, serious disadvantages, impairing, for example, negotiations and informal settlements—"the lifeblood of the administrative process." [51]

From the foregoing examination conflicting conclusions may be drawn. It may be argued that the dangers of prejudice at the agency level were viewed as slight primarily because the broad scope and "sheer volume of work [do] not permit the agency heads to participate actively in developing one side," [52] and that the remaining dangers were permitted to exist only because the costs of complete separation were too great. The argument continues that the dangers presented by the superior/subordinate combination increase when the review function is delegated below the agency level both because the scope of the delegate's job is likely to be narrowed, and because his closeness to the prosecutor is increased. At the same time the costs of complete separation at the lower level, at least in the Post Office, are relatively slight. Moreover, the mere fact that delegation was contemplated does not compel the conclusion that a combination of functions is also delegable: the agency exemption clause clearly cannot be applied to the General Counsel. While these arguments are persuasive, those leading to an opposite conclusion appear equally so. Although the agency exemption cannot be applied to the General Counsel, the contemplation of delegation and the disadvantages of separation may justify interpretation of section 5(c) to permit the relatively slight danger of the remote combination of functions here involved. Moreover, the absence of expressed

46. *Attorney General's Committee Report* 57.

47. See *ibid.* Nor did the report of the minority, recommending complete separation, evince concern about this danger. *Id.* at 203-09.

48. *Id.* at 57.

49. See *Attorney General's Committee Report* 57-60; *cf. APA, Legislative History* 204, 262.

50. *Attorney General's Committee Report* 53, 150.

51. *Id.* at 59-60.

52. *Id.* at 57.

concern about the existence of the superior/subordinate relationship may well indicate that the dangers flowing from this relationship were considered too insignificant to require interference with existing agency procedures, even absent a cost consideration. Finally, the act as a whole may be viewed as an attempt to prescribe only minimal standards of fairness,[53] removing only the major dangers of prejudice rather than every danger.

Argument based on the intent of Congress, in the broad sense, will thus serve both sides. Whether a court is justified in reading into the ambiguous provisions of a statute a requirement such as the one here contemplated is a matter more of philosophical approach than of legal analysis. It depends, ultimately, upon the court's conception of its own role as the means by which the legislative will is effectuated in particular instances. If the court deems it its function to deal with the ultimate legislative ambiguity by resolving the issue on its substantive merits, it will, when presented with a question of this type, decide on the basis of policy considerations of its own choice. If, however, it defines the scope of judicial competence as one which stops the court from acting at the outer limits of the ambiguity, it will conclude that in such a case judicial wisdom requires the exercise of judicial restraint.[54]

CIVIL PROCEDURE—EXTRATERRITORIAL SERVICE PROVISIONS OF SECURITIES ACT HELD INAPPLICABLE TO COMMON-LAW ACTION FOR RESCISSION JOINED WITH SECURITIES ACT ALLEGATION

Plaintiff, a citizen of Pennsylvania, instituted suit in the Federal District Court for the Eastern District of Pennsylvania seeking rescission, under the Securities Act of 1933,[1] of an allegedly unlawful sale of stock made in Pennsylvania by defendants, citizens of New York. Defendants were served in New York pursuant to section 77v(a) [2] of that act, which permits service of process extraterritorially wherever defendant may be found. As the result of new matter disclosed during the taking of depositions,[3] plaintiff filed an amended complaint including an allegation of mutual mistake and seeking rescission under state common law. Service

53. JAFFE, ADMINISTRATIVE LAW—CASES AND MATERIALS 110 (1954); *APA, Legislative History* 193, 250.

54. For conflicting views on the role of the courts in this situation, *compare* Simpson, *Robert H. Jackson and the Doctrine of Judicial Restraint,* 3 U.C.L.A.L. REV. 325, 346-48 (1956), *and* Frankfurter, *Some Reflections on the Reading of Statutes,* 47 COLUM. L. REV. 527 (1947), *with* Radin, *Statutory Interpretation,* 43 HARV. L. REV. 863 (1930). For an exposition of Judge Hand's own views, see Lancaster, *Judge Learned Hand and the Limits of Judicial Discretion,* 9 VAND. L. REV. 427 (1956).

1. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1952).

2. 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77v(a) (Supp. V, 1958).

3. Plaintiff's Brief *Contra* Defendant's Motion To Dismiss Counts 2 and 3 of Amended Complaint, p. 2.

of the amended complaint was had upon defendants' attorney in Pennsylvania, pursuant to rule 5 of the Federal Rules of Civil Procedure.[4] Defendants moved to dismiss, contending that service of the amended complaint, not having been made upon defendants personally in Pennsylvania, was not in accordance with Federal Rule 4(f) requiring service of process within the state in which the court sits unless otherwise authorized by federal statute. The court held that, since the state action set forth in the amended complaint did not arise under the Securities Act, the extraterritorial service provisions of that act were inapplicable, and service of process must be had within the state in which the district court sits. The court also held that rule 5 does not apply unless the amended complaint could have properly been served originally by the method used in serving the complaint which it amends.[5] *Lasch v. Antkies,* 161 F. Supp. 851 (E.D. Pa. 1958).

An action under the Securities Act of 1933 may properly be brought in any district in which "the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place. . . ."[6] To supplement this liberal venue provision, the act makes possible the service of process extraterritorially "in any other district of which the defendant is an inhabitant or wherever the defendant may be found."[7] Thus, under the facts of the instant case, it is clear that as to plaintiff's claim under the Securities Act venue was properly laid and service of process effective. It is also clear that the instant court had jurisdiction on grounds of diversity of citizenship over the subject matter of plaintiff's action for rescission based upon mutual mistake. Venue as to that action would also be properly laid in the instant court.[8] Viewing that action separately, however, service of process could not be had extraterritorially but would be limited by rule 4(f) to Pennsylvania, the state in which the district court sits.[9] The question presented by the instant case is whether

4. FED. R. CIV. P. 5(a) provides, in pertinent part: "[E]very pleading subsequent to the original complaint . . . shall be served upon each of the parties affected thereby. . . ." FED. R. CIV. P. 5(b) provides, in pertinent part: "Whenever under these rules service is required or permitted to be made upon a party represented by an attorney the service shall be made upon the attorney unless service upon the party himself is ordered by the court. . . ."

5. The court also ruled that the provisions of FED. R. CIV. P. 5, permitting service of an amended complaint upon the attorney of record, did not dispense with the requirement of personal service within the jurisdiction in the instant situation. The court granted defendants' motion to dismiss, treating it as a motion to set aside and vacate service of the amended complaint, with leave granted to defendants to renew the motion to dismiss if proper service has not been made within one year of the filing of the amended complaint. Instant case at 853.

6. Securities Act of 1933, §22(a), 48 Stat. 86 (1933), as amended, 15 U.S.C. §77v(a) (Supp. V, 1958).

7. *Ibid.*

8. 28 U.S.C. §1391(a) (1952).

9. FED. R. CIV. P. 4(f) provides that: "All process . . . may be served anywhere within the territorial limits of the state in which the district court is held and, when a statute of the United States so provides, beyond the territorial limits of that state."

that limitation must be applied to the state-law claim when that claim is joined with an action under the Securities Act.[10] Relaxation of the limitation would seem permissible by analogy to the doctrine of ancillary jurisdiction[11] as set forth in the case of *Hurn v. Oursler*.[12] In that case, the Supreme Court held that a district court, having jurisdiction over a federal claim because of the existence of a substantial federal question, may dispose of the case upon a non-federal claim if the two are but "different grounds asserted in support of the same cause of action."[13] In *Hurn* there was no diversity of citizenship between the parties and personal service had been had on defendant in the state in which the court sat. Therefore, the question was whether the court had jurisdiction over the subject matter of the non-federal claim. The requirement that the federal and state claims be but different grounds of recovery for the same cause of action has been subject to varying interpretation by the several circuits. In *Hurn* the Court pointed out that the state and federal claims rested upon identical facts. The Second Circuit has extended the application of the doctrine only slightly to situations where the claims rest upon facts which are substantially identical.[14] Other circuits have given the test less stringent application[15] and the Ninth Circuit has allowed joinder of a state claim of fraud in the sale of land with a federal claim under the Securities Exchange Act of 1934,[16] relying on the presence of a "single fraudulent scheme."[17] The instant court viewed the *Hurn* doctrine as applying only to jurisdiction. Yet it would seem apparent that if the considerations underlying that doctrine are sufficient to overcome the constitutional objection of lack of jurisdiction, they are at least equally sufficient to justify a liberal interpretation of the statutory service requirements as set forth in rule 4(f).

10. It is apparent that had Congress so desired it could have validly authorized service of process of any federal district court to run anywhere within the territorial limits of the United States. United States v. Union Pac. R.R., 98 U.S. 569 (1878). It has seen fit to do so only as to certain statutes. See, *e.g.*, Public Utility Holding Company Act of 1935, § 25, 49 Stat. 835 (1935), as amended, 15 U.S.C. § 79y (1952).

11. The doctrine of ancillary jurisdiction first appeared in Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 737 (1824), where the Court held that a federal court may decide state-law issues when necessary to the decision of a federal question, because the constitutional power to decide a "case" must include the power to decide all issues necessary to a decision. In Siler v. Louisville & N.R.R., 213 U.S. 175 (1909), this concept was extended to permit a federal court to adjudicate state-law issues which were unnecessary to the decision of a federal claim in order to avoid a federal constitutional question.

12. 289 U.S. 238 (1933).

13. 289 U.S. at 247.

14. Zalkind v. Scheinman, 139 F.2d 895 (2d Cir. 1943), *cert. denied*, 322 U.S. 738 (1944); Treasure Imports, Inc. v. Henry Amdur & Sons, Inc., 127 F.2d 3 (2d Cir. 1942); Note, 52 YALE L.J. 922 (1943). In Zalkind v. Scheinman, *supra*, Judge Clark dissented, espousing the more liberal view that the consideration of judicial economy should be adequate to justify the extension of the *Hurn* doctrine to cover situations where there was a common central matter basic to both claims.

15. See, *e.g.*, Manosky v. Bethlehem-Hingham Shipyard, Inc., 177 F.2d 529 (1st Cir. 1949); Strachman v. Palmer, 177 F.2d 427 (1st Cir. 1949); United Lens Corp. v. Doray Lamp Co., 93 F.2d 969 (7th Cir. 1937).

16. 48 Stat. 881 (1934), as amended, 15 U.S.C. § 78a-jj (1952).

17. Errion v. Connell, 236 F.2d 447, 454 (9th Cir. 1956).

In the situation presented by the instant case, if extraterritorial service as to both claims is not allowed, plaintiff, desiring to bring his fraud action in a district proper under the Securities Act, must forego litigation of his ancillary state-law claim in the same suit unless defendant can be personally served within that district. If plaintiff chooses to bring the Securities Act action separately, he may be permitted, should he lose, to bring a second suit in defendant's district, where proper service may be had.[18] The nature of the dispute in question, however, seems to require that it be adjudicated in a single suit. The allegations of fraud and of mutual mistake are but alternative versions of the same transaction. Adjudication in separate suits thus seems undesirable from the standpoint of judicial economy. Moreover, proof of one theory disproves the other.[19] Thus, even though it may be clear that plaintiff should recover on one theory or the other, the bringing of separate suits may result in an ultimate judgment for defendant because of disagreement on the part of the individual courts or juries as to which theory of recovery is proper. Plaintiff, of course, can avoid these problems by bringing the combined action in the district where defendant resides. But in so doing he must forego the liberal venue provisions of the Securities Act, which are indicative of the congressional view that at least some securities actions might be better brought in a district other than that of defendant's residence. For example, the availability of proof might make the district where the transaction occurred, as in the instant case, a particularly appropriate forum.

Balanced against the foregoing considerations are the arguments against a relaxation of the service requirements to permit extraterritorial service of the joint complaint in the instant situation. The limitation of service of process to the state in which the district court sits is in part analogous to defendant's venue rights; he is protected from the inconvenience of being forced to defend a suit in a foreign jurisdiction. It is apparent that this argument has little merit here, however, since defendant can be compelled to litigate in Pennsylvania the very same transaction, under the Securities Act allegation of fraud as to which venue and service are proper.[20] The danger exists that plaintiff could present a

18. If plaintiff voluntarily brings two suits he runs the risk that after judgment for defendant in one suit, the court having jurisdiction of the second suit will determine that both claims could and should have been asserted in the prior action and therefore the first judgment is res judicata to the maintenance of the second suit. RESTATEMENT, JUDGMENTS § 63 (1942). On the other hand, if plaintiff attempts to bring both claims together and the court determines that jurisdiction of one is lacking, a second suit should not be barred. RESTATEMENT, JUDGMENTS § 67 (1942).

19. Section 12 of the Securities Act, 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77*l* (1952), provides: "Any person who [misrepresents a material fact in the sale of a security] and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission shall be liable to the person purchasing such security from him. . . ." Thus, the affirmative defense of mistake, if proven, will completely absolve the seller from liability under this section.

20. See 28 U.S.C. § 1404(a) (1952) providing for change of venue for the convenience of parties and witnesses, in the interest of justice, to any other district where the action might have been brought—the doctrine of forum non conveniens.

state-law claim and, in bad faith, join with it a federal statutory claim solely in order to utilize the extraterritorial service provision of the federal statute. The application of the *Hurn* doctrine, however, presupposes the existence of a substantial federal claim. Under that doctrine, defendant is free to contest jurisdiction if it becomes apparent during pre-trial, or the early stages of trial, that the federal claim is not substantial or that the two claims rest upon dissimilar facts.[21] So too could defendant move to quash service if bad faith or dissimilarity of facts appears. Under a system in which discovery and pre-trial are readily available, the problem of bad faith joinder does not appear insurmountable. It may be argued further that, since the federal district courts sit as the alter-ego of the state courts in cases in which jurisdiction is founded solely upon diversity of citizenship, restriction of the process of a state court to those physically within its borders[22] should be applied with equal force to the federal district courts. Theoretically this may be true, but in *Hurn*-type cases jurisdiction does not rest upon the state-law claim, as to which diversity is lacking, but rather upon the presence of a substantial federal question; jurisdiction of the federal claim carries with it jurisdiction of the state-law claim when that claim is but "different grounds asserted in support of the same cause of action."[23] The same rationale may be applied to this analogous situation in order that a federal court, properly chosen by the plaintiff to hear his federal claim, may adjudicate ancillary claims.[24] This result is consistent with the congressional policy that liberal venue provisions should apply to cases arising under and concerning the Securities Act. On

21. *Cf.* Kleinman v. Betty Dain Creations, Inc., 189 F.2d 546 (2d Cir. 1951).

22. See Pennoyer v. Neff, 95 U.S. 714 (1877).

23. Hurn v. Oursler, 289 U.S. 238, 247 (1933).

24. The instant court said that the ancillary jurisdiction doctrine applies only to questions of jurisdiction and not to service of process, citing as authority Pearce v. Pennsylvania R.R., 162 F.2d 524 (3d Cir. 1947). That case involved a claim of negligence against the railroad under the Federal Employers' Liability Act, 39 Stat. 742 (1916), as amended, 15 U.S.C. §§ 751-93 (1952), and against an individual on state common-law grounds, diversity of citizenship being lacking. The court dismissed the state-law claim for lack of jurisdiction, ruling that it stated not an ancillary cause of action but a separate and distinct cause of action. The decision was based upon a dissimilarity of issues between the parties due to differences in measure of liability under state and federal law. The instant court also relied upon Moreno v. United States, 120 F.2d 128 (1st Cir. 1941), in which suit was brought against the United States in a federal district court in Massachusetts to recover the proceeds of a policy of war risk insurance. The Government interpleaded the named beneficiary as third party defendant and obtained extraterritorial service of process in New Jersey as authorized by the World War Veteran's Act of 1924, 43 Stat. 612, as amended, 38 U.S.C. § 445 (1952). Plaintiff then filed an amended complaint asserting a state-law claim against the third party defendant for alienation of affections. The district court denied leave to amend. The First Circuit affirmed, ruling that the district court had jurisdiction over the third party defendant for the limited purpose of determining who was entitled to the proceeds of the insurance policy. As such, her appearance did not constitute a waiver or estop her to assert that in a suit against the United States under the statute she could be summoned in as a third party defendant only for the purpose of determining whether she was entitled to the proceeds of the policy. It is clear that the *Moreno* case is not controlling here, as the introduction of the third party complaint in that case would have involved substantially different proof upon each claim. In the instant case, the two claims are based on the same transaction. See text following note 18 *supra*.

balance, the desirability of permitting the disposition of the entire cause of action in a single suit seems to outweigh the foregoing objections to extending jurisdiction in the instant case. A liberal interpretation of rule 5 to permit service as here made, and the application to this situation of the *Hurn* doctrine, thus seem preferable to the position taken by the instant court of isolating each claim and, on the pleadings, without consideration of the particular facts, requiring separate service of process.[25]

CORPORATION LAW—CONVERSION OF PREFERRED STOCK CALLED FOR REDEMPTION TO COMMON OF EQUIVALENT VALUE NOT A "PURCHASE" WITHIN SECTION 16(a) OF THE SECURITIES EXCHANGE ACT

In 1948 defendant acquired a number of shares of convertible preferred stock of Ashland Oil and at that time became a director of the corporation. These preferred shares were convertible at any time before July 1958 into Ashland common stock on a share-for-share basis. Their convertibility was protected against dilution by automatic adjustment of the conversion ratio to offset proportionately any change in the number of common shares outstanding. Both Ashland common and Ashland preferred were registered securities listed on the New York Stock Exchange, where, because of the secured convertibility of the preferred, they tended to sell at equivalent prices. The preferred stock was subject to call for redemption at a fixed rate upon thirty days notice, but during the thirty days the conversion privilege remained available. In 1951, at a time when Ashland preferred was selling on the market for $36 a share, the corporation called all of the outstanding preferred stock for redemption at $27, expecting and intending that all holders would exercise their conversion privileges. Defendant converted, and then, within six months of conversion, sold a block of the common stock thus acquired at prices in excess of the price of common on the conversion date. Upon demand of a stockholder, the corporation brought action against defendant under section 16(b) of the Securities Exchange Act for recovery of profits realized by a corporate director's

25. In spite of the court's holding, it is conceivable that a plaintiff in the instant situation may be able to obtain service even though defendant does not voluntarily enter the jurisdiction. Subject to a showing of hardship under FED. R. CIV. P. 30(b), a party defendant may be required to come into the district for purposes of giving oral deposition. FED. R. CIV. P. 30(a). O'Neill v. Blue Comet Cab Corp., 19 F.R.S. 525 (S.D.N.Y. 1953). Although defendant, while in the district to give his deposition, is generally immune from service of process in another suit, it does not necessarily follow that he is immune from service of process in connection with the same suit. The immunity granted rests in part upon a desire to encourage compliance with court orders without fear of harassment by way of a second suit. But it is said to be a privilege of the court rather than of the individual and should not be extended beyond the reason upon which it is based. Accordingly, it has been held that where the attempted service of process pertains to the same suit precipitating the individual's appearance in the district, no immunity attaches. Lamb v. Schmitt, 285 U.S. 222 (1932); Roth v. W. T. Cowan, Inc., 103 F. Supp. 203 (E.D.N.Y. 1952); Ferguson v. Ford Motor Co., 92 F. Supp. 868 (S.D.N.Y. 1950).

short-swing "purchase and sale" of equity securities of his own corporation. Judgment for defendant was affirmed on appeal; exercise of the conversion privilege did not constitute a "purchase" within the meaning of the act. *Ferraiolo v. Newman,* 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 27 U.S.L. WEEK 3244 (U.S. March 2, 1959).

Intended to deter the speculative stock manipulations of those whose access to confidential intra-corporate information might give them an inequitable market advantage, section 16(b) of the SEA [1] requires corporate insiders to disgorge for the corporation's benefit all profits realized upon short-term in-and-out trading in stock of their own companies.[2] "Prophylactic" [3] rather than punitive or compensatory, the section eschews all tests of manipulative intent or actual misuse of inside information in the individual case [4] and defines by arbitrary and objective rules of thumb the transactions to which it applies.[5] Upon a showing that the contested deal-

1. "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer ["every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security"] by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." Securities Exchange Act of 1934, §16(b), 48 Stat. 896, 15 U.S.C. §78p(b) (1952).

2. See generally Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934,* 12 SW. L.J. 147 (1958); Cook & Feldman, *Insider Trading Under the Securities Exchange Act,* 66 HARV. L. REV 385, 612 (1953); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders,* 95 U. PA. L. REV. 468 (1947); Tracy & MacChesney, *The Securities Exchange Act of 1934,* 32 MICH. L. REV. 1025 (1934); Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of the Securities Exchange Act,* 38 MICH. L. REV. 133 (1939).

3. Frey, *Federal Regulation of the Over-the-Counter Securities Market,* 106 U. PA. L. REV. 1, 30 (1957).

4. The act imposes liability "irrespective of any intention on the part of [the insider] in entering into such transaction of holding the securty purchased or of not repurchasing the security sold for a period exceeding six months." See note 1 *supra.* See Statement of Mr. Corcoran, *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 and S. Res. 56 and S. Res. 97,* 73d Cong., 2d Sess. 6557 (1934): "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Cf.* SEC v. Chenery Corp., 318 U.S. 80, 92 (1943).

5. Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir. 1954); Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943); LOSS, SECURITIES REGULATION 564 (1951); Cook & Feldman, *supra* note 2, at 410; Hardee, *Stock*

ings are within the category reached by the statute—"any purchase and sale, or any sale and purchase, . . . within any period of less than six months" of any equity security by a director, officer or ten per cent stockholder of the issuing corporation[6]—recovery of profits is automatic, and it is no defense that the insider in question could in fact have had no access to any confidential information.[7] Moreover, pursuant to the statutory policy "to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty," [8] the courts have uniformly construed 16(b) as broadly and inclusively as possible.[9] The terms "purchase" and "sale" particularly have been given "the broadest possible connotation," [10] and the accepted standard of interpretation is that any acquisition or disposal of securities will be held a purchase or sale "which might reasonably be considered in the category of a 'purchase' or 'sale' in connection with which an insider might profit by the use of confidential information to the detriment of the outside stockholders and the corporation." [11] Acquisitions under various types of options have given the courts some difficulty in assessing the scope of "purchase" within the terms of the section;[12] but in all cases to date involving the exercise of warrants, stock options or conversion rights, the transactions have been held to fall within the statute.[13] In the leading case of *Park & Tilford, Inc. v.*

Options and the "Insider Trading" Provisions of the Securities Exchange Act, 65 HARV. L. REV. 997, 998 (1952); Yourd, *supra* note 2, at 133-34; Comment, 27 TEXAS L. REV. 840, 841 (1949).

6. See note 1 *supra.*

7. Pellegrino v. Nesbit, 203 F.2d 463 (9th Cir. 1953); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), *cert. denied,* 346 U.S. 820 (1953); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943); Comment, 5 STAN. L. REV. 139, 140-41 (1952).

8. Smolowe v. Delendo Corp., *supra* note 7, at 239.

9. Cole, *supra* note 2, at 150; Note, 59 YALE L.J. 510, 533 (1950).

10. Truncale v. Blumberg, 80 F. Supp. 387, 390-91 (S.D.N.Y. 1948).

11. *Ibid.* The court in the instant case enunciated the stardard in similar terms: "Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16 (b)." Instant case at 345. The "kind of transaction" test, it should be noted, is not intended to provide for a scheme of abstracted categories with uniform internal rules such, for example, that *all* conversion cases or *all* stock reorganization cases or *all* warrant cases will be similarly treated. In assessing whether a given dealing meets the test, the courts have evidenced a willingness to look to all of the relevant idiosyncratic factors of the particular instance except those bearing on potential access to confidential information, actual abuse of confidence or insider intent, as to which see text and notes at notes 4-6 *supra.* In Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir. 1954), the court, resting its decision upon a detailed analysis of interlocking factors peculiar to the case, expressly declined "enunciation of a black letter rubric."

12. Rubin & Feldman, *supra* note 2, at 485.

13. Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (5th Cir.), *cert. denied,* 346 U.S. 820 (1953); Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949); Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947). *Cf.* Blau v. Hodgkinson, 100 F. Supp. 361, 373 (S.D.N.Y. 1951). See generally Note, 59 YALE L.J. 510, 533 (1950).

Under its statutory power to exempt particular transactions or classes of transactions from the operation of § 16(b) "as not comprehended within the purpose of this section," Securities Exchange Act of 1934, § 16(b), 48 Stat. 869-70, 15 U.S.C. § 78p(b)

Schulte,[14] defendant insiders, holders of convertible preferred stock that had been called for redemption at a price lower than the current market value of the equivalent common, exercised their conversion privilege and subsequently sold within six months a number of shares of common. Holding the transaction within the purview of 16(b), the court said: "We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language." [15] The court further rejected defendants' argument that conversion was involuntary and "forced," holding that "here defendants were not forced to convert, but instead made an everyday business decision as to the most profitable of three courses of action—redemption, conversion, or outright sale of their preferred." [16]

In declining to hold defendant's conversion a "purchase" in the instant case, the court reasoned that Ashland preferred, because of its undilutable conversion privilege was "the economic equivalent of the common,"[17] so that to exchange the former for the latter neither gave a holder anything that he had not already possessed nor created any new speculative opportunity that had not existed from the time of the acquisition of the preferred in 1948. Moreover, the conversion was "in a very real sense involuntary," [18] inasmuch as the call of the preferred at $27 when its current common equivalent marketed at $36 left defendant no reasonable alternative.[19] No inside information was necessary to a decision to convert to avoid a loss of $9 per share; that opportunity was offered equally to all preferred shareholders and substantially all of them in fact exercised the

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(1952), the SEC has promulgated rule X-16B-3, 17 C.F.R. § 240.16b-3 (Supp. 1958), exempting acquisition of stock or nontransferable stock options or the purchase of stock by exercise of such options "pursuant to a bonus, profit-sharing, retirement, stock option, thrift, savings or similar plan" meeting specified qualifications. But the Second Circuit has given notice by considered dictum in Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957), that it deems rule X-16B-3 beyond the SEC's statutory competence as comprehending transactions which do fall within the purpose of 16(b). See 1957 U. ILL. L.F. 664. Note that stock options are themselves equity securities within the purview of the act. Questions involving the acquisition and disposal of such options, quite apart from their exercise, have been much litigated. See, *e.g.*, Pellegrino v. Nesbit, 203 F.2d 463 (9th Cir. 1953); Shaw v. Dreyfus, *supra;* see Cole, *supra* note 2; Note, 59 YALE L.J. 510 (1950).

14. 160 F.2d 984 (2d Cir.), *cert. denied,* 332 U.S. 761 (1947).

15. *Id.* at 987. The court continued: "Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by the definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' § 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose to protect the outside stockholders against at least short-swing speculation by insiders with advance information."

16. *Id.* at 988.

17. Instant case at 345.

18. *Id.* at 346.

19. The court noted that defendant might have avoided the $9 per share loss as well by outright sale of the preferred shares on the open market as by conversion but argued that "it can hardly be said that a failure to sell is tantamount to a purchase." *Id.* at 346. For discussion see text below note 26 *infra.*

option.[20] *Park & Tilford* was distinguished in that Park & Tilford preferred had been an unlisted stock with convertible privileges unprotected from dilution. It was thus essentially unmarketable; insiders who desired to engage in short-swing speculation could do so only by acquisition of the common.[21] And whereas the Park & Tilford insiders had had complete control of the corporation with absolute power to call or not to call the preferred, defendant in the instant case was a very inactive director, not in fact privy to any inside information or in exercise of any inside control, and hence entirely subject to the compulsive pressure of the threatened $9 loss.

In assessing the cogency of this reasoning, it should first be recalled that any arguments based upon defendant's innocence and good faith as disculpatory in themselves are wholly incompetent under the objective standard of 16(b).[22] Similarly, contentions that defendant did only what the corporation expected and intended that he do,[23] and that all stockholders were treated equally in calling in the preferred,[24] if advanced merely to demonstrate the fairness of defendant's dealings, will not suffice to take the transaction out of the operation of the section. These last three arguments may, however, be viewed in another light, as subsumed in what the instant court calls the "involuntary" [25] nature of the conversion. Since

20. Holders of more than 99% of outstanding Ashland convertible preferred exercised the conversion privilege after call. Instant case at 345.

21. This argument is more fully developed in the district court opinion in the instant case. Ashland Oil & Ref. Co. v. Newman, 163 F. Supp. 506 (N.D. Ohio 1957). There it was pointed out that potential Park & Tilford speculators *"had* to have common stock, which sold on the New York Stock Exchange, before they could hope to reap a quick profit." *Id.* at 507. (Emphasis by the court.) It should be noted that the Second Circuit opinion in *Park & Tilford* pursues no such analysis; in fact it entirely fails to relate that Park & Tilford preferred was unlisted. See text and note at note 15 *supra.*

22. See text and note at note 7 *supra.* The district court in the instant case expressly places great weight upon defendant's innocence. Ashland Oil & Ref. Co. v. Newman, *supra* note 21, at 508. The court of appeals, although explicitly disavowing the subjective good faith standard, instant case at 344, seems also somewhat influenced by the equitably unimpeachable character of defendant's transactions.

23. Under a statute designed to protect outside stockholders and securities investors from the machinations of insiders, acquiescence by the corporation, presumptively controlled by those very insiders, obviously cannot be permitted to legitimate a transaction which otherwise falls within the ban of the section. Express management approval of contested insider transactions has repeatedly been held no defense in 16(b) actions. Magida v. Continental Can Co., 231 F.2d 843 (2d Cir. 1956) (sale made at specific instance and request of management to promote potential business relations between issuing corporation and competitors of defendant inside stockholder); Jefferson Lake Sulphur Co. v. Walet, 104 F. Supp. 20 (E.D. La.), *aff'd,* 202 F.2d 433 (5th Cir. 1952), *cert. denied,* 346 U. S. 820 (1953); Pellegrino v. Nesbit, 203 F.2d 463 (9th Cir. 1953) (considered dictum).

24. That opportunities to acquire different or additional stock are equally and nonpreferentially distributed among all existing stockholders does not guarantee that there will be no room for advantageous exercise of preferentially acquired insider information in the exercise of those opportunities. See Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949), where purchase warrants were evenhandedly distributed as stock dividends to all stockholders of record. Although receipt of the warrants was held no "purchase" under the act, exercise of those warrants was held a purchase. *Id.* at 142. *Cf.* Blau v. Hodgkinson, 100 F. Supp. 361 (S.D.N.Y. 1951). *But see* Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954).

25. Instant case at 346.

volition as going to defendant's actual motivation is withdrawn from judicial consideration in 16(b) cases, the reasoning of the court seems to be that the instant situation, being one in which the insider has as a matter of practicality only one possible course of action, is of a kind which offers little or no opportunity of speculative abuse. Although the preferred stockholder is offered the three apparent choices of conversion, redemption or outright sale, sound business judgment conclusively dictates conversion. Sale of the preferred not only entails surrender of his equity in the corporation, but may run the risk of depressing the market; redemption involves loss of $9 a share. So compelling are these considerations that owners of more than ninety-nine per cent of Ashland convertible preferred in fact elected to convert. Clearly, where all of the open and obvious economic conditions surrounding the transaction so far supply motive for conversion, there is little need to fear that potential abuse of confidential information will further influence the insider's calculus. Such a case, it may be argued, is quite remote from the type of short-swing double dealing contemplated by the congressional prohibition.

On the other hand, it should be considered that, however involuntarily put into a position of election,[26] the insider who holds convertible preferred will find among his available alternative transactions very different opportunities for future trading. His preferred has been called for redemption in thirty days. Within that time he must either sell at $36 or convert into $36 worth of common. Possible confidential information as to what may be expected to happen to common stock values at a time subsequent to the thirty-day period but within six months may well be a factor in that decision. In the instant case, the common stock increased in value shortly after the thirty days and defendant sold, realizing a profit he would not have made on earlier sale of the preferred. The view of the court, then, that defendant's conversion "created *no* opportunity for profit which had not existed" already as inherent in the possession of the preferred,[27] forgets that whatever speculative opportunity inhered in the preferred was threatened with imminent expiration and that to pursue any trading advantage expected (whether or not through abuse of insider knowledge) at

26. In *Park & Tilford,* where the elective privilege of conversion was in fact more narrowly circumscribed than that of defendant in the instant case because the Park & Tilford insiders were trustees required by state law to follow the alternative which preserved the highest integral value of the stock holdings, conversion was said to be voluntary and was held a purchase. See text and notes at notes 15, 16 *supra.* The instant court attempts to distinguish *Park & Tilford* on the ground that whereas the Park & Tilford insiders were in actual control of the corporation and could have defeated the calling of convertible preferred for redemption, defendant here was a very inactive director without any such powers of control. To this it may be argued that under the objective rule of thumb prescribed by 16(b), persons enumerated in that section—directors, officers and ten per cent stockholders—may be conclusively presumed to have whatever "control" is requisite for liability under the act. "[T]he persons liable . . . and the measure of liability are both based upon arbitrary rules of thumb, independent of any proof of actual use of confidential information." Cook & Feldman, *supra* note 2, at 410. See text and notes at notes 4, 5 *supra.*

27. Instant case at 346. (Emphasis added.)

a later date, defendant had to have the common. What is true, as suggested above, is that far more probably than not, an insider's action in this posture will be dictated by other legitimate motives rather than the intent to get out on the short swing. But can it therefore be said, under the standard adopted by the instant court, that the transaction here is not "of a kind which *can possibly* lend itself to . . . speculation. . . ."?[28] The criterion of mere possibility has in fact been that adopted by prior decisions[29] and seems most suited to the congressional intent to wholly incapacitate insiders from deriving profits on short-swing trading set up by acquisitions susceptible of motivation by confidential information. By subjecting the transactions here involved to 16(b), those legitimate objectives which more probably, but not to the exclusion of all possibility of abuse, motivate conversion are not frustrated. The holder of preferred may at his option convert, saving his $9 per share from redemption, retaining his control in the corporation and avoiding a possible flood of sales on the market. But whatever speculative opportunity would otherwise have inhered in conversion, as compared with sale, has been sterilized. In sum, it is submitted that the instant court should have followed *Park & Tilford*[30] in holding the conversion a "purchase" under the act.[31]

28. *Id.* at 345. (Emphasis added.) See note 11 *supra.*

29. Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954); Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957), 1957 U. ILL. L.F. 664 (considered dictum that SEC cannot exempt a class of transactions as not within purpose of 16(b) despite SEC contention that possibility of speculative abuse is slight; see note 13 *supra*). See text and notes at notes 9, 10, 11 *supra. But see* Roberts v. Eaton, 212 F.2d 82 (2d Cir. 1954), where a more lenient test may have been applied.

30. It is conceded that the distinctions noted by the court between *Park & Tilford* and the instant case are relevant and persuasive and that the situation here is a more difficult one for application of 16(b) inasmuch as there will in general be fewer instances in which conversion may serve as a speculative instrument where both stocks are equally marketable and tend to sell at equivalent values. But under the any-possibility-of-abuse test, see text and notes at notes 11, 29 *supra,* enough danger appears to inhere even in the latter instance to call for the applicability of the section. A more difficult case still would be a conversion where the convertible security has not yet been called for redemption and the conversion privilege is due to remain viable for more than six months to come. In such a case, there seems little conceivable speculative opportunity in holding common which does not also inhere in the possession of convertible preferred. This seems to be the situation envisaged in Note, 59 YALE L.J. 510, 524 (1950), where it is argued that conversion should not be deemed a "purchase" for 16(b) purposes. But see Blau v. Mission Corp., 212 F.2d 77 (2d Cir. 1954), where an exchange of stock of A corporation for stock of B corporation, a holding company whose whole assets were shares of A corporation stock, was held a "sale" within 16(b) although the court recognized that the intrinsic value of B stock was absolutely tied to the underlying A stock. It is suggested that, absent a finding in the individual case of factors which would tend to create greater market demand under stipulated conditions for the conversion stock than for the convertible stock (such might be the case, for instance, where a customary lag in processing conversion notices so far exceeds the corporation's usual processing time for the recording of stock transfers that rumors of an imminent common stock dividend might cause disparity of common and convertible preferred prices for a short period immediately preceding a rumored cut-off date), conversion of a stock where loss of the conversion privilege is not impending should not be held a "purchase" for 16(b) purposes, since whatever profits may inure to the insider from subsequent sale are not legitimately attributable to the six-month short swing.

31. This result is in accord with the analysis in Note, 59 YALE L.J. 510, 525-26 (1950).

CRIMINAL PROCEDURE—APPEAL MAY BE TAKEN TO ONE COUNT OF MULTI-COUNT CONVICTION WHERE CONCURRENT SENTENCES HAVE BEEN IMPOSED

Convicted on three counts of an indictment charging him with possessing, forging, and uttering a stolen United States Treasury check,[1] defendant was sentenced to three years on each count, the sentences to run concurrently. When defendant appealed only the conviction on the second count, possessing a stolen check,[2] the Government moved to dismiss on the ground that the failure to attack all the counts made the appeal futile and without merit. The United States Court of Appeals for the Second Circuit denied the motion to dismiss and reversed the judgment on count two.[3] *United States v. Hines,* 256 F.2d 561 (2d Cir. 1958).

Federal appellate courts generally will not consider on the merits claims of error relating to conviction on one or more counts of a multi-count indictment where the trial court imposed concurrent sentences, and conviction under at least one count is admittedly proper.[4] The rationale of the rule, which originated in *Claassen v. United States,*[5] is that an appeal under such circumstances would be futile, since the appellant remains obligated to serve his original sentence regardless of the outcome of the appeal. In that case the defendant was convicted on five of eleven counts, and sentenced to six years on a general judgment which made no reference to any specific counts. On appeal the Supreme Court considered only the sufficiency of the first count and stated that "in any criminal case a general verdict and judgment on an indictment or information containing several counts cannot be reversed on error, if any one of the counts is good and warrants the judgment, because, in the absence of anything in the record to show the contrary, the presumption of law is that the court awarded sentence on the good count only." [6] While the *Claassen* doctrine was predicated upon a situation where a general judgment making no reference to specific counts was issued, it has been extended to preclude

1. Violation of 18 U.S.C. §§ 1708 and 495 (1952). Defendant was acquitted on a fourth count, which charged unlawful possession of another such check.

2. Violation of 18 U.S.C. § 1708 (1952).

3. The court also vacated the sentences on the remaining two counts and remanded the action for further proceedings in accordance with its opinion.

4. Lawn v. United States, 355 U.S. 339 (1958); Pinkerton v. United States, 328 U.S. 640 (1946); Hirabayashi v. United States, 320 U.S. 81 (1943); Sinclair v. United States, 279 U.S. 263 (1929); Pierce v. United States, 252 U.S. 239 (1920). All eleven federal circuits have had occasion to apply the rule. See cases collected 25A FED. DIG. *Criminal Law* § 1177 (1951). State courts have adopted the same rule for the most part. See, *e.g.,* People v. Ponce, 96 Cal. App. 2d 327, 215 P.2d 75 (Dist. Ct. App. 1950); People v. Podsiad, 295 Mich. 541, 295 N.W. 257 (1940); State v. Merritt, 231 N.C. 59, 55 S.E.2d 804 (1949). *But see* People v. Branch, 119 Cal. App. 2d 490, 260 P.2d 27 (Dist. Ct. App. 1953). See also cases collected DEC. DIG. *Criminal Law* § 1177.

5. 142 U.S. 140 (1891).

6. *Id.* at 146. For a recent case with dictum indicating that the Supreme Court may still follow the *Claasen* rule today, but nevertheless reversing a concurrent sentence, see Greene v. United States, 79 Sup. Ct. 340 (1959).

review where concurrent sentences have been imposed and a defendant is appealing less than all of the separate counts on which he has been convicted.[7]

For almost forty years the federal courts have consistently applied the modified *Claassen* rule in the multitude of cases which have presented the problem.[8] Indeed, the *Claassen* doctrine has become so imbedded in the law that its mandate is currently applied automatically and universally without consideration of the facts in any individual case. The instant court does not attempt to discard *Claassen* completely but rather suggests that an examination of the circumstances in a multi-count appeal should be made before the doctrine of automatic dismissal takes effect. The court stated:

> "[W]e feel constrained to entertain an appeal such as this whenever the nature of the error committed below or other circumstances suggest that the accused might have received a longer sentence than otherwise would have been imposed, or that he has been prejudiced by the results of the proceedings." [9]

It is submitted that this relaxation of the *Claassen* rule is correct. Putting aside the question whether the *Claassen* presumption that the sentence was awarded on the good count only is valid, its application in a situation where concurrent sentences are issued on a multi-count indictment is not readily justifiable. In the latter instance the defendant is convicted and sentenced for separate crimes. By definition the defendant is sentenced on each count. There is no reason to presume that the sentence was on the good count only; indeed the presumption is exactly the opposite. Concurrent sentences are awarded with an awareness of the multi-count conviction and are imposed with this in mind. Thus, concurrent sentences imposed for a conviction of eleven offenses may not be identical in terms of length with the sentence which would be imposed if only one of the eleven offenses were properly sustainable.[10] In cases where reversal on less than all counts has occurred, the courts have recognized that reduction in sentence may often follow.[11] The instant case is itself a good example, since, on

7. See cases cited note 4 *supra.*

8. The last federal case to reject the *Claassen* doctrine was Robinson v. United States, 30 F.2d 25 (6th Cir. 1929). It has been sixty-three years since the Supreme Court failed to apply the doctrine. Putnam v. United States, 162 U.S. 687 (1896). There have been other examples of its rejection in cases of similar although not identical situations. See, *e.g.,* Ballew v. United States, 160 U.S. 187 (1895), which involved a general judgment rather than conviction on each of separate counts. In United States v. Tarricone, 242 F.2d 555 (2d Cir. 1957), and United States v. DiCanio, 245 F.2d 713 (2d Cir. 1957), where one count became merged in the aggravated offense of the other count, the court held that the sentence under the count setting forth the lesser offense must be set aside.

9. Instant case at 563.

10. See Yates v. United States, 356 U.S. 363 (1958). In *Yates,* the defendant appealed all eleven counts.

11. See *ibid;* Robinson v. United States, 30 F.2d 25, 29 (6th Cir. 1929), where the court stated: "Under the circumstances of this case, the imprisonment sentence

remand, the district court reduced the sentences from three years to two years on the remaining two counts.[12] The *Claassen* rule presumes that the district judge gives the same punishment on a one-count conviction as he does on a multi-count conviction, thereby making it futile for defendant to appeal one of the counts. The underlying theory is faulty, however, since there is at least a probability that the sentence will be reduced in some proportion to the reduction of guilty counts. Application of the *Claassen* doctrine in the instant case may also have deprived defendant of an earlier parole. The legislative purpose of the federal parole system is the restoration of good risk offenders to society.[13] Thus, the parole board is granted discretionary power to release prisoners upon such criteria as "a reasonable probability that such prisoner will live and remain at liberty without violating the laws," and "if in the opinion of the Board such release is not inconsistent with the welfare of society." [14] The practical result is that a prisoner serving a sentence for one count stands better in the eyes of the parole board than a prisoner serving a sentence for many counts, and this is true even if we assume both prisoners are serving identical sentences in terms of time.[15] The instant court's determination not to apply *Claassen* may also be justified on one final ground. The "stigma" of being labeled a multi-count offender lasts long after the parole board stage of a man's life. The danger of the situation is particularly apparent when a man carries a morally reprehensible crime on his record simply because he was simultaneously guilty of a far less heinous offense. For example, under the Narcotic Drugs Import and Export Act[16] one can simultaneously be indicted for selling heroin to juveniles[17] and for having in his possession a narcotic drug.[18] A defendant convicted on both of these counts would be seriously prejudiced if he were not allowed to appeal the conviction for peddling heroin to juveniles although he admits guilt as to possession. On the other hand, if entertaining a concurrent sentence appeal would be futile in terms of practical value to the defendant, application of the *Claassen* rule is judicially sound. For example, where a defendant is appealing only one minor count of a dozen-count conviction, it would appear to be a

upon the four counts having been deemed by the trial judge to be appropriate punishment also for the five, we are not clear that the sentence as to the four ought to stand and at the same time a new trial be had as to the five. . . . The convictions and sentences upon the first five counts are reversed, the convictions upon the last four counts are affirmed, but the sentences thereon are reversed; and the case remanded for further proceedings."

12. Letter From Benson H. Begun, Counsel for Defendant, to *University of Pennsylvania Law Review*, Oct. 17, 1958, on file in Biddle Law Library, University of Pennsylvania.

13. Neal v. Hunter, 172 F.2d 660 (10th Cir. 1949).

14. 18 U. S. C. § 4203(a) (1952).

15. See Hibon v. United States, 204 F.2d 834, 839 (6th Cir. 1953): "[I]t is well understood that a multiplicity of sentences impairs a prisoner's opportunities for pardon or parole."

16. 42 Stat. 598 (1922), as amended, 21 U.S.C. §§ 171-84 (1952).

17. 70 Stat. 570 (1956), 21 U.S.C. § 176a (Supp. V, 1958).

18. 42 Stat. 596 (1922), as amended, 21 U.S.C. § 174 (1952).

waste of time for the court to hear the appeal. The focus in any given case, however, should be to determine whether reversal of one or more counts could reasonably result in important advantages to the defendant. The instant court is really advocating no more than the use of judicial discretion in each appeal, rather than automatic dismissal under the *Claassen* rule.

INCOME TAX—Contributions in Aid of Capital Construction Made by Prospective Customers to Corporation Held Taxable as Income to Corporation

Hills surrounding the cities of Wilkes-Barre and Kingston, Pennsylvania prevent adequate reception of television signals by means of conventional roof-top antennas. In order to provide television service for the community, petitioner, a Pennsylvania corporation, planned to construct a mountain-top tower by means of which television signals could be intercepted, and to convey those signals by coaxial cables an average distance of five miles to home television sets. Because of the high degree of risk present in this pioneer business [1] and the fear that UHF stations might make the system obsolete within a short time,[2] it was decided that adequate capital could best be raised by obtaining contributions from prospective customers. Contributors were divided into two classes—residential and commercial, with the latter making a somewhat larger initial contribution.[3] The program also provided for a monthly maintenance and service charge when the system became operative.[4] Customers signed a contract with petitioner company whereby payment of the initial contribution was required to make the customer eligible to pay the monthly maintenance charge which entitled him to receive the signal. Petitioner segregated all funds received as contributions and applied them only to construction costs; the monthly charges were used for normal operating expenses. In filing its income tax return, petitioner neither included the contributions from subscribers in gross income nor claimed depreciation for the facilities constructed with them. The Commissioner, however, treated the contribu-

1. Only two community antenna systems were available for close study—one in operation at Lansford, Pennsylvania and one under construction in Pottsville, Pennsylvania. Instant case at 106.

2. At the time petitioner was organized in 1951 there were no UHF stations in the vicinity, but it was known that applications were on file. In fact, what at one time was a system high of 900 customers had fallen by 1956 to 400 due to UHF competition. Instant case at 106.

3. Commercial customers made an initial payment of $200, while residential customers paid $145. Instant case at 107.

4. The monthly charge was six dollars for commercial customers and four dollars for residential customers. Instant case at 107.

tions as gross income and determined a tax deficiency for the two-year period covered by the returns, at the same time allowing a deduction for depreciation of the physical assets. Petitioner contested this ruling and a subsequent tax court affirmance. The court of appeals sustained the determination, holding that the contributions were part payment for services rendered and consequently taxable as gross income. *Teleservice Co. v. Commissioner,* 254 F.2d 105 (3d Cir.), *cert. denied,* 257 U.S. 919 (1958).

Gross income, as defined by the Internal Revenue Code of 1939, includes "gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid . . . or gains or profits and income derived from any source whatever." [5] Petitioner contended, however, that the payments by subscribers were "contributions to capital," and thus came within the long recognized exception to gross income laid down initially in *Edwards v. Cuba R.R.,*[6] in which subsidies paid by the Cuban government to induce railroad construction were held not taxable as gross income. Later decisions have extended the *Cuba Railroad* doctrine to cases in which residents contributed to a fund to make cash or property available as an inducement to a manufacturer to locate in the community,[7] and to cases in which companies donated property or cash to other firms in order to induce expansion or relocation.[8] The doctrine has also been applied when, as in the instant case, the making of the contributions was a condition precedent to receiving service, chiefly when residents of rural areas have paid costs of transmission lines as well as monthly service charges in order to receive electric light and power,[9] and when railroad customers have made contributions toward the costs of spur track facilities and also paid the normal service rates.[10] There is no question, as the court conceded, that some of these cases are factually indistinguishable from the instant case. The court reasoned, however, that a broader concept of income has recently been advanced by the Supreme Court—that of "tax[ing] all gains except those specifically exempted." [11]

5. Int. Rev. Code of 1939, ch. 1, § 22(a), 53 Stat. 9.

6. 268 U.S. 628 (1925). For conflicting views as to the correctness of the doctrine of this case, *compare* Rottschaefer, *The Concept of Income in Federal Taxation,* 13 MINN. L. REV. 637 (1929), *with* Harvey, *Some Indicia of Capital Transfers Under the Federal Income Tax Laws,* 37 MICH. L. REV. 745 (1939).

7. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950); Commissioner v. McKay Prods. Corp., 178 F.2d 639 (3d Cir. 1949); Frank Holton & Co., 10 B.T.A. 1317 (1928).

8. Arundel-Brooks Concrete Co. v. Commissioner, 129 F.2d 762 (4th Cir. 1942); Kauai Ry., 13 B.T.A. 686 (1928).

9. Tampa Elec. Co., 12 B.T.A. 1002 (1928); Wisconsin Hydro-Elec. Power Co., 10 B.T.A. 933 (1928); El Paso Elec. Ry., 10 B.T.A. 79 (1928); Rio Elec. Co., 9 B.T.A. 1332 (1928); Liberty Light & Power Co., 4 B.T.A. 155 (1926).

10. Union Pac. R.R., 26 B.T.A. 1126 (1932); Texas & Pac. Ry., 9 B.T.A. 365 (1927); Great No. Ry., 8 B.T.A. 225, *aff'd,* 40 F.2d 372 (8th Cir. 1927).

11. Commissioner v. LoBue, 351 U.S. 243, 246 (1953) (gain to employee exercising stock purchase option held taxable); *accord,* General Am. Investors Co. v. Commissioner, 348 U.S. 434 (1955) ("insider profits" received pursuant to Securities Exchange Act of 1934 held taxable as income); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (punitive treble damages held includable as gross income).

The court also relied heavily upon *Detroit Edison Co. v. Commissioner*,[12] in which the Supreme Court, in holding that payments made by customers to aid in power line construction could not be included in depreciation basis, stated that

> "it overtaxes the imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the company. The transactions neither in form nor in substance bore such a semblance. The payments were to the customer the price of the service." [13]

The court viewed this case as removing payments which were the price of service from the contributions-to-capital exemption.

Although *Detroit Edison* has been viewed as foreshadowing a contraction of the *Cuba Railroad* doctrine,[14] the instant case is the first to apply the rationale of *Detroit Edison* to hold payments received from prospective customers includable within gross income in situations factually indistinguishable from decisions to the contrary based on the *Cuba Railroad* doctrine. However, the opinion of the instant court does not indicate a complete rejection of the *Cuba Railroad* doctrine and the decisions which developed thereunder. The court distinguished *Cuba Railroad* factually.[15] Moreover, when section 118 of the 1954 Code,[16] providing that "gross income does not include any contribution to the capital of the taxpayer," is considered in connection with section 362(c),[17] providing that property or money acquired by a corporation as a contribution to capital takes a zero basis when contributed by a non-shareholder, it becomes clear that some contributions by non-shareholders are exempted. Although those provisions were not applicable to the instant case, there is no question but that the court would refuse to view the contributions here made as coming within their purview.[18] The extent to which future payments by non-shareholders will be held includable in income thus seems likely to depend on the distinction drawn between the factual situation present in the instant case and that of *Cuba Railroad*. The court regarded as controlling the fact that the contributions in question were made by prospective cus-

12. 319 U.S. 98 (1943).

13. *Id.* at 102-03.

14. Note, 3 TAX L. REV. 568 (1948).

15. Instant case at 112. In order to reach its result, the only alternative to distinguishing *Cuba Railroad* would have been for the court to conclude that it had been overruled by *Detroit Edison*. Such a position would appear untenable.

16. INT. REV CODE OF 1954, § 118.

17. INT. REV. CODE OF 1954, § 362(c).

18. "[T]he Committee Reports accompanying Sections 118 and 362 of the 1954 Code (also cited by taxpayer) make it clear these provisions are not applicable to contributions or other payments by persons who are direct beneficiaries of the service rendered by the recipient corporation." Instant case at 112-13.

tomers of the taxpayer, and were required as a prerequisite to receiving service. Emphasis was also given to the absence of a community or public benefit, as opposed to a direct benefit to the individual contributor. Applying these tests to the various types of cases formerly held as falling within the contributions-to-capital exemption,[19] it would appear that contributions for power line and spur track extensions are includable within gross income under the rule of the instant case,[20] although they may not be so treated by the Internal Revenue Service.[21] On the other hand, general community donations to induce plant relocation, where the only benefit to the individual is the over-all benefit to the community, apparently will still be held excludable from gross income.[22] A more difficult situation is that in which one company induces another to relocate near it by offering cash or property. In such a case the direct benefit to the individual merges with the general benefit to the community. In view of the fact that the payment in such a case is a prerequisite not to service but merely to more efficient or advantageous service, it would appear to fall outside the rule of the instant case.[23]

From an economic viewpoint, the instant case seems likely to operate as a deterrent to expansion into high risk enterprises or marginal service areas. To the extent that corporate taxpayers decide that expansion can be justified only if construction costs are paid in advance by those directly benefiting from the expansion, the inclusion in gross income of contributions made by these persons will increase the amount of the contribution required. Particularly where the contributors are private individuals, this increase will have a tendency to contract substantially the area in which expansion will be feasible.[24] The effect is somewhat decreased by the fact that a deduction can be taken for depreciation of the assets purchased with

19. See text accompanying notes 7-10 *supra*.

20. Assuming, of course, that the contributions are made by prospective customers rather than by the community at large.

21. The Commissioner has indicated that he will distinguish payments made to public utilities by prospective customers, continuing to treat them as excludable from income in accordance with past decisions cited in notes 9, 10 *supra*. 1 CCH 1959 STAND. FED. TAX REP. ¶ 631.6884 (TIR).

22. See Treas. Reg. § 1.118-1 (1956).

23. The approach adopted by the American Law Institute in its proposed statute differs somewhat from both the 1939 and 1954 Code provisions. Contributions to capital are excluded from gross income and given a substituted basis. These contributions are defined as those made by shareholders and those made for a "public purpose," "neither as payments for goods or services furnished . . . nor a payment in lieu of income or to supplement income." ALI FED. INCOME TAX STAT. §§ X107(k), X276(b)(7) (Feb. 1954 Draft). It is clear that the payments made in the instant case and in *Detroit Edison* would be without the scope of this exclusion. They would be, however, within the provision excluding "contributions to operating facilities," which contributions are those made "in order that the enterprise may extend its service to prospective customers making the contribution." *Id.* § X107(*l*) & comment. These contributions take a zero basis. *Id.* § X277(b)(10).

24. In the view of the drafters of the ALI statute, failure to exclude initial charges for television cable systems from income may make the construction of such systems impractical. *Id.* § X107(*l*), comment.

contributed funds.[25] Whether the remaining deterrence is sufficiently great to require or justify special treatment for corporate taxpayers receiving contributions of this nature, however, is a matter for congressional, rather than judicial, determination.

LABOR LAW—EMPLOYER DOMINATION OF LABOR-MANAGEMENT COMMITTEE NOT AN UNFAIR LABOR PRACTICE

To promote increased production and efficiency in critical industries during World War II, the War Production Board encouraged the formation of employee-management committees. With the Board's approval employees at petitioner's plants periodically elected representatives to committees which, during the ensuing years, met monthly with management representatives and discussed and made recommendations concerning problems of mutual interest including safety, efficiency, seniority, job classifications, working schedules, vacations and sick leave, and improvement of working facilities. Employer assisted in holding the committee elections and meetings, and defrayed all expenses of the committees. The committees functioned in both unionized and non-union plants, and in the latter they presented individual employee grievances to management. The National Labor Relations Board ordered petitioner to disestablish the committees because they were employer-dominated labor organizations.[1] The Court of Appeals for the Fifth Circuit, reversing, held that the committees were not "labor organizations" as defined in section 2(5) of the Taft-

25. In *Detroit Edison* the assets purchased with contributed funds were held not depreciable, the Court reasoning that the payments could not be considered part of the cost of the assets to the taxpayer. The Court's refusal to view the payments as capital contributions took the basis question out of the operation of § 113(a)(8)(B) of the 1939 Code (ch. 1, 53 Stat. 42), which provided that capital contributions took the basis of the transferor. The question of depreciability of the assets thus became dependent upon an interpretation of § 113 (ch. 1, 53 Stat. 40), now § 1012, providing that the basis of property shall be its cost. It must be noted, however, that in that case the contributions had not been taxed originally as income and had depreciation been allowed the taxpayer would have received a double benefit. Under the 1954 Code, contributions to capital, made non-taxable as income by § 118, take a zero basis for depreciation purposes, under § 362, when made by a non-shareholder, thus eliminating the double benefit possibility in *Cuba Railroad*-type cases. It seems fairly certain that had the payments in *Detroit Edison* been taxed as income, a different conclusion would have been reached on the depreciation question. Under the provisions of the 1954 Code, the Commissioner will apparently disallow deductions for depreciation of assets purchased with funds received as contributions in aid of capital construction only to the extent that the amounts so received were not reported as taxable income to the corporation. 1 CCH 1959 STAND. FED. TAX REP. ¶ 631.6884 (TIR).

1. A disestablishment order is the usual practice in the event of dominated labor organizations. See, *e.g.*, NLRB v. Folk Corp., 308 U.S. 453 (1940); NLRB v. Newport News Shipbuilding & Dry Dock Co., 308 U.S. 241 (1939); 16 NLRB ANN. REP. 155 (1951).

Hartley Act[2] but were authorized by section 9(a)[3] which permits individuals and groups of employees to present grievances to their employer. Domination of the committees by petitioner was therefore not an unfair labor practice under section 8(a)(2).[4] *Cabot Carbon Co. v. NLRB*, 256 F.2d 281 (5th Cir.), *cert. granted*, 358 U.S. 863 (1958) (No. 329).

Congress in section 2(5) of the Taft-Hartley Act has defined a "labor organization" as "any organization of any kind, or any agency or employee representation committee or plan, in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning grievances, labor disputes, wages, rates of pay, hours of employment, or other conditions of work."[5] It is an unfair labor practice for an employer to dominate or support the formation or administration of any such organization.[6] By amendment to section 9(a) of the National Labor Relations Act,[7] Congress, in seeking to overrule prior decisions[8] that adjustment of individual and group grievances could be made only with the consent and participation of the bargaining representative,[9] provided that individuals and groups of employees may, without union intervention, effect final settlements of "grievances" not inconsistent with the collective bargaining agreement, provided the union representative is given an opportunity to be present at the adjustment.[10] Several courts have recognized a conflict between the right of groups to adjust grievances independent of the collective bargaining process or agreement, and the right of a labor organization as exclusive bargaining representative to deal with employers concerning grievances.[11] In a case arising under circumstances similar to

2. Labor Management Relations Act, §2(5), 61 Stat. 138 (1947), 29 U.S.C. §152(5) (1952) (hereinafter cited by LMRA section number only): "The term 'labor organization' means any organization of any kind, or any agency or employee representation committee or plan, in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning grievances, labor disputes, wages, rates of pay, hours of employment, or conditions of work."

3. LMRA §9(a): "Representatives designated or selected for the purposes of collective bargaining by the majority of the employees in a unit appropriate for such purposes, shall be the exclusive representatives of all employees in such unit for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment: *Provided*, That any individual employee or group of employees shall have the right at any time to present grievances to their employer and to have such grievances adjusted, without the intervention of the bargaining representative, as long as the adjustment is not inconsistent with the terms of a collective bargaining contract or agreement then in effect: *Provided further*, That the bargaining representative has been given the opportunity to be present at such adjustment."

4. LMRA §8(a)(2): "It shall be an unfair labor practice for an employer to dominate or interfere with the formation or administration of any labor organization or to contribute financial or other support to it. . . ."

5. LMRA §2(5). See note 2 *supra*.

6. LMRA §8(a)(2). See note 4 *supra*.

7. Ch. 372, §9(a), 49 Stat. 453 (1935).

8. See, *e.g.*, Hughes Tool Co. v. NLRB, 147 F.2d 69 (5th Cir. 1945).

9. See S. REP. No. 105, 80th Cong., 1st Sess. 24 (1947), quoted note 36 *infra*.

10. LMRA §9(a). See note 3 *supra*.

11. See cases cited notes 12, 13 *infra*.

those in the instant case, the Sixth Circuit held an employer-dominated employee committee was not a labor organization but a group under section 9(a).[12] Distinguishing grievances in 9(a) from those in 2(5), the court said 2(5) grievances included those "major" disputes which are the subjects of collective bargaining—wages, hours, and other conditions of employment—and which affect employees as a class or fix the future rules of employment for everyone in the unit. Section 9(a) grievances were said to be those claims, peculiar to individuals or groups, that their rights under the collective bargaining agreement have not been respected, raising questions of the meaning of the contract or involving situations not covered by the contract with respect to which an adjustment is made.[13] In all other cases determining the status of employee-management committees similar to those in the instant case, whether or not the decision was based on this test, such committees were held to be labor organizations and ordered disestablished since they adjusted grievances or dealt with employers concerning conditions of employment or other subjects of collective bargaining, even though, as in the instant case, no collective bargaining agreement was contemplated.[14] The Second Circuit, however, holding that a minority union may adjust grievances under 9(a), has rejected the grievance distinction and suggested that grievances in both sections include all disputes in connection with the employment relationship not inconsistent with the collective bargaining agreement.[15] The instant court similarly rejected the grievance distinction as a basis for determining whether the committees were labor organizations. Instead, it rested its holding that petitioner's committees were not labor organizations on two grounds: first, the term "dealing with" in 2(5) means "bargaining with," and since this group of employees "avoided the usual concept of collective bargaining" and did not "exist for the purpose of negotiating or bargaining with employers," it was not a labor organization. Second, the court concluded it was the intention of Congress that the act should permit the existence of employee-management committees.[16]

12. NLRB v. Associated Machs., 219 F.2d 433 (6th Cir. 1955).

13. The distinction has also been drawn in other contexts. See Elgin, J. & E.R.R. Co. v. Burley, 325 U.S. 711, 722 (1945) (Railway Labor Act); West Texas Util. Co. v. NLRB, 206 F.2d 442 (D.C. Cir. 1953), *cert. denied*, 346 U.S. 855 (1955) (refusal to bargain collectively); Hughes Tool Co. v. NLRB, 147 F.2d 69 (5th Cir. 1945) (union's right to adjust grievances under NLRA § 9(a)).

14. See, *e.g.*, NLRB v. Standard Coil Prods. Co., 224 F.2d 465 (1st Cir.), *cert. denied*, 350 U.S. 902 (1955); NLRB v. Stow Mfg. Co., 217 F.2d 900 (2d Cir. 1954), *cert. denied*, 348 U.S. 964 (1955); NLRB v. Sharples Chems., Inc., 209 F.2d 645 (6th Cir. 1954); Indiana Metal Prods. Corp. v. NLRB, 202 F.2d 613 (7th Cir. 1953); NLRB v. General Shoe Corp., 192 F.2d 504 (6th Cir. 1951), *cert. denied*, 343 U.S. 904 (1952); Gullett Gin Co. v. NLRB, 179 F.2d 499 (5th Cir.), *rev'd on other grounds*, 340 U.S. 361 (1950).

15. Douds v. Local 1250, Retail Wholesale Dep't Store Union, CIO, 173 F.2d 764 (2d Cir. 1949). For a criticism of this holding see West Texas Util. Co. v. NLRB, 206 F.2d 442 (D.C. Cir. 1953), *cert. denied*, 346 U.S. 855 (1955); *Developments in the Law—The Taft-Hartley Act*, 64 HARV. L. REV. 781, 843-44 (1951).

16. Instant case at 285-89. The second ground of the court's holding is discussed at notes 36-38 *infra*.

The instant court's rejection of the distinction between 9(a) and 2(5) grievances as a basis for determining whether or not petitioner's committees were labor organizations seems realistic in light of modern collective bargaining practices. A certified bargaining representative, clearly a labor organization as defined in section 2(5), may properly present any grievance of an individual in the bargaining unit at his request pursuant to provisions in collective bargaining contracts which embody procedures for such adjustment.[17] Moreover, few grievance adjustments are strictly individual. The union has an interest in seeing that successive adjustments of even petty individual grievances are uniformly applied. Moreover, any adjustment involving an interpretation of the bargaining contract will inevitably affect other employees subject to the contract and therefore affect the future status of the employment relationship.[18]

Nevertheless, it does not appear that the instant court's holding that petitioner's committees "avoided the usual concept of collective bargaining" and had no "bargaining powers" is a test that should be determinative of their status. Section 2(5) defines a labor organization as "any organization . . . which exists for the purpose . . . of dealing with employers. . . ." [19] The instant court held that the term "dealing with" means "bargaining with" and that since collective bargaining is a process of negotiation which looks toward the making of an agreement, and petitioner's committees had no intent to make an agreement, those committees were not labor organizations.[20] The result of this reasoning is that any representative group which does not collectively bargain is not a labor organization under section 2(5). However, it is clear that it is an unfair labor practice for an employer to dominate or interfere with the formation of a group which is seeking recognition as the certified bargaining representative,[21] but which by the terms of section 9(a) may not, until so recognized, represent employees for the purpose of collective bargaining.[22] It would seem, therefore, that whether a representative body of employees performs the functions of collective bargaining is not determinative of whether employer domination of that group is an unfair labor practice. Conceding, however, that the ultimate purpose of a labor organization is to achieve that status which will enable it to collectively bargain, it appears that the instant court unduly restricted its definition of the term "bargain-

17. See MATTHEWS, LABOR RELATIONS AND THE LAW 344-45 (1953). See, *e.g.*, Jenkins v. Schluderberg-T. J. Kurdle Co., 217 Md. 556, 144 A.2d 88 (1958).

18. It is true, however, that arbitrators often feel free to disregard prior awards, and the doctrine of stare decisis has limited application in the settlement of grievances. See, *e.g.*, *In re* Gorton-Pew Fisheries Co., 16 Lab. Arb. 365 (1951); *In re* General Elec. Co., 9 Lab. Arb. 757 (1948). However, the following of precedent is conducive to good labor relations and avoids a multiplicity of disputes.

19. LMRA §2(5). See note 2 *supra*.

20. Instant case at 285.

21. See LMRA §§ 8(a) (2), 9(b). See, *e.g.*, NLRB v. L. Ronney & Sons Furniture Mfg. Co., 206 F.2d 730 (9th Cir. 1953), *cert. denied*, 346 U.S. 937 (1954); American Smelting & Ref. Co. v. NLRB, 128 F.2d 345 (5th Cir. 1942).

22. LMRA §9(a). See note 3 *supra*.

ing." Collective bargaining is a continuing process which involves, not merely the making of an agreement, but preliminary negotiation and day-to-day resolution of employer-employee problems whether or not covered by a contract.[23] Thus, the presentation by the employee-management committees of recommendations on such subjects as seniority, work schedules, vacations and sick leave, and the resultant decision on those recommendations were in themselves a form of collective bargaining.[24] It would seem, therefore, that the employer domination of these committees was an unfair labor practice.

However, even if the instant court's holding that petitioner's committees were not labor organizations is correct, it would seem, nevertheless, that petitioner's assistance in holding elections, requiring the calling of meetings at specified times, and defraying of expenses necessary to the operation of the committees [25] were an unfair interference with employees' right to engage in concerted activities for their mutual aid and protection.[26] Employees' right to self-organize, "to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection" is guaranteed by section 7 of the act.[27] Employer interference with section 7 rights is an unfair labor practice under section 8(a)(1).[28] The very existence of an employee representative group and the election of representatives thereto are probably in themselves "concerted activities . . . for other mutual aid or protection." [29] If so, petitioner's interference is clearly prohibited by section 8(a)(1). While "concerted activities" generally refers to employees' right to engage in strikes, picketing and other forms of economic pressure,[30] and not every form of concerted activity is given protection under sections 7 and 8(a)(1),[31] the right to act collectively may

23. See, *e.g.*, the language of the opinion in Conley v. Gibson, 355 U.S. 41, 46 (1957): "Collective bargaining is a continuing process. Among other things, it involves day-to-day adjustments in the contract and other working rules, resolution of new problems not covered by existing agreements, and the protection of employee rights already secured by contract."

24. *Ibid.*

25. See instant case at 283.

26. LMRA §7: "Employees shall have the right to self-organization, to form, join or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection. . . ."

27. *Ibid.*

28. LMRA §8(a)(1): "It shall be an unfair labor practice for an employer . . . to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7."

29. LMRA §7. See note 26 *supra.*

30. See, *e.g.*, Salt River Valley Water Users' Ass'n v. NLRB, 206 F.2d 325 (9th Cir. 1953); Cusano v. NLRB, 190 F.2d 898 (3d Cir. 1951).

31. See, *e.g.*, NLRB v. J. I. Case Co., 198 F.2d 919 (8th Cir. 1952), *cert. denied*, 345 U.S. 917 (1953) (seizure of employers' business); Joanna Cotton Mills Co. v. NLRB, 176 F.2d 749 (4th Cir. 1949) (circulation of petition for removal of foreman); NLRB v. Draper Corp., 145 F.2d 199 (4th Cir. 1944) (wildcat strike).

be exercised irrespective of the existence of a labor organization,[32] and collective bargaining need not be contemplated.[33] Petitioner, therefore, having supervised elections and organized the committees interfered with rights guaranteed employees by section 7, irrespective of whether labor-management committees are labor organizations. However, even if the formation and operation of the committees were not "concerted activities," section 7 guarantees employees the right to self-organization. Where, as in petitioner's non-union plants, this right remains as yet unexercised, the establishment and subsequent domination of an employee representative group, by giving employees a false sense of independent representation, may undercut unionization and prevent or forestall any employee self-organization. In dealing with a dominated group the employer is in fact dealing with himself. This would seem to preclude the equality of representation and fair handling of disputes contemplated by the act.

The instant court based its decision principally on the congressional history of the 9(a) proviso. The court felt that, although the Conference Committee rejected a House Hartley Bill amendment[34] permitting the formation by employer of employee committees to discuss subjects of collective bargaining in the absence of a certified bargaining representative, that amendment was implicit in the amended 9(a) proviso. The court based its conclusion on the fact that the conference report indicated that the House provision was omitted because the 9(a) proviso gave sufficient employee protection in allowing individual and group settlement of grievances. Therefore, the court concluded, Congress intended to include labor-management committees within the guarantees of the 9(a) proviso.[35] However, the history of the amended provision is clear in only one respect. Congress intended merely to overrule prior decisions that the adjustment of individual grievances could be made only with the intervention of the bargaining representative as a party to the decision, and to create an independent right in individuals and groups to confer with employers and adjust

32. See Salt River Valley Water Users' Ass'n v. NLRB, 206 F.2d 325 (9th Cir. 1953); Joanna Cotton Mills Co. v. NLRB, *supra* note 31; NLRB v. Phoenix Mut. Life Ins. Co., 167 F.2d 903 (7th Cir.), *cert. denied*, 335 U.S. 845 (1948); Western Cartridge Co. v. NLRB, 139 F.2d 855 (7th Cir. 1944).

33. See, *e.g.*, NLRB v. Phoenix Mut. Life Ins. Co., *supra* note 32; Bethlehem Shipbuilding Corp. v. NLRB, 114 F.2d 930 (1st Cir.), *cert. denied*, 312 U.S. 710 (1940). The Board has held, *e.g.*, that solicitation on behalf of a union, Marshall Field & Co., 98 N.L.R.B. 88 (1952), attendance at conference with employer, Camp & McInnes, Inc., 100 N.L.R.B. 524 (1952), and petitioning employer not to recognize a union as bargaining representative, Coca Cola Bottling Co. of Ashville, 97 N.L.R.B. 503 (1951), are among the concerted activities protected by the act.

34. H.R. 3020, 80th Cong., 1st Sess. § 8(d)(3) (1947): "Notwithstanding any other provision of this section, the following shall not constitute or be evidence of an unfair labor practice under any of the provisions of this Act: Forming or maintaining by an employer of a committee of employees and discussing with it matters of mutual interest, including grievances, wages, hours of employment, and other working conditions, if the Board has not certified or the employer has not recognized a representative as their representative under Section 9."

35. Instant case at 285-89.

individual rights.[36] The expressed intent neither considers nor indicates that a dominated employee committee was intended to come within the protection of the 9(a) proviso. To conclude that Congress considered the Hartley amendment implicit in section 9(a) because, rejecting the amendment, it felt 9(a) gave sufficient employee protection would seem to be a less reasonable inference than that Congress felt 9(a) was sufficient in itself and as far as the legislature wanted to go, and therefore something less than the Hartley amendment was intended. Moreover, the Hartley amendment permitted labor-management committees to perform the functions of a bargaining representative only in the absence of a certified bargaining representative.[37] The instant committees did more than adjust grievances in non-union plants; they performed functions of a bargaining representative in already unionized plants—functions which would have been prohibited even by the Hartley amendment.[38] It seems clear, therefore, that labor-management committees of the type instituted by petitioner are within neither the provisions nor the policy of the Taft-Hartley Act nor intended to be so by Congress.

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36. See S. REP. No. 105, 80th Cong., 1st Sess. 24 (1947): "Section 9(a): The revisions of section 9 relating to representation cases make a number of important changes in existing law. An amendment contained in the revised proviso for section 9(a) clarifies the right of individual employees or groups of employees to present grievances. The Board has not given full effect to this right as defined in the present statute since it has adopted a doctrine that if there is a bargaining representative he must be consulted at every stage of the grievance procedure, even though the individual employee might prefer to exercise his right to confer with his employer alone. The current Board practice received some support from the courts in the *Hughes Tool* case (147 F. (2d) 756 [*sic*]) a decision which seems inconsistent with another circuit court's reversal of the Board in *NLRB v. North American Aviation Company* (136 F. (2d) 898). The revised language would make it clear that the employer's right to present grievances exists independently of the rights of the bargaining representative, if the bargaining representative has been given an opportunity to be present at the adjustment, unless the adjustment is contrary to the terms of the collective bargaining agreement then in effect."

37. See note 34 *supra*.

38. As has been shown (see cases cited notes 12, 14 *supra*), numerous irreconciled conflicts have arisen among the courts with regard to the interpretation of the roll which Congress intended to relegate to the section 9(a) proviso. The instant decision is but one aspect of that confusion. While it is beyond the scope of this Comment to develop the point further, it may be well to point out that interpretations of this section as now constituted are not only presently irreconciled but probably irreconcilable. In addition to the confusion arising from the attempt to coordinate section 2(5) with the proviso and the great difficulty in defining a grievance solution of which will not be "inconsistent with the terms of the collective bargaining contract," a single example of this irreconcilability may suffice. The proviso states that the bargaining representative must be given the "opportunity to be present at such [*i.e.*, individual or group] adjustment [of grievances]." LMRA §9(a). If "present" means mere sitting in without right to participate or appeal the result, the entire policy of the act in having a strong, exclusive bargaining agent is seriously weakened. If "present" means more, the proviso language, that individuals or groups have the right to adjust grievances "without intervention of the bargaining representative," is meaningless. It is suggested that legislative action, most likely repeal of the 9(a) proviso, with substitution of other methods of protecting individual rights is in order.

NEGLIGENCE—LANDOWNER HELD NOT LIABLE TO INFANT TRESPASSER IN ABSENCE OF ACTUAL KNOWLEDGE OF DANGEROUS CONDITION

Plaintiff, a five-year-old child, was seriously burned when he wandered onto a vacant lot owned by defendant and stumbled into a fire on the premises.[1] In an action to recover damages for personal injuries resulting from his allegedly negligent maintenance of a dangerous condition upon the land, defendant asserted that the fire had been set by third persons without his consent or knowledge. In reversing a verdict for plaintiff and remanding for a new trial, the Supreme Court of New Jersey held that the landowner must be shown to have had actual knowledge[2] of the existence on his land of a condition dangerous to children when such condition had been created by third persons, and that therefore the trial court's charge that constructive knowledge is sufficient to fix liability constituted prejudicial error. *Simmel v. New Jersey Coop Co.*, 143 A.2d 521 (N.J. 1958).

The duty of an owner or occupier of land toward persons entering on the land varies according to the circumstances under which the person enters. Generally, the landowner must use due care to maintain the premises in a safe condition for the benefit of his business invitees,[3] those whom he invites or permits to enter to conduct business dealings.[4] His duty toward social guests and mere licensees, those persons permitted to enter solely for their own benefit, is somewhat less; he must merely warn them of dangerous conditions of which he has knowledge.[5] No such affirmative duty is owed toward adult trespassers, the duty being limited to refraining from negligently injuring them by active operations once their presence

1. The premises had previously been used by the city as a dump, and the fires which injured the plaintiff consisted of burning rubbish and garbage. There is some evidence that the fires had been in continual existence for some time. Defendant had purchased the lot twenty-one days before the accident for use as a plant site. Although construction had begun on the plant, there is some indication that the fires were not seen from the vicinity of the construction. Instant case at 523.

2. The court in the instant case would include imputed knowledge as actual knowledge, *i.e.*, if an agent or servant of the owner has actual knowledge of the existence of the condition, such actual knowledge is imputed to the owner whether or not he personally has such knowledge. Instant case at 527.

3. The *Restatement of Torts* uses the term "business visitor" which it defines as "a person who is invited or permitted to enter or remain on land in the possession of another for a purpose directly or indirectly connected with business dealings between them." RESTATEMENT, TORTS § 332 (1934). Generally, the presence of a possible financial benefit to the landowner is the principal factor in determining whether the person entering is a business invitee. 2 HARPER & JAMES, TORTS § 27.8 (1956); PROSSER, TORTS 453 (2d ed. 1955); RESTATEMENT, TORTS § 332, comment *b* (1934).

4. On the duty owed business invitees, see generally PROSSER, *op. cit. supra* note 3, at 459. This duty is considered the price the landowner must pay for the economic benefit he derives from the presence of the visitor. In the alternative, it is said that the landowner made an implied representation that reasonable care had been exercised in making the place safe for such invitees. *Id.* at 453-55.

5. *Id.* at 77. There is still some authority that there is no duty owed licensees except to refrain from inflicting intentional harm. SMITH & PROSSER, CASES ON TORTS 783 n.1 (1952).

has been discovered.[6] Originally, no distinction was drawn between adult and infant trespassers; both entered the premises at their peril.[7] In 1873, however, the United States Supreme Court, in *Railroad Co. v. Stout*,[8] held that the likelihood of the presence of children, coupled with the likelihood of harm coming to them from dangerous conditions on the premises, gave rise to a land occupier's duty to use care to prevent such harm. Dissatisfaction with this ruling led some states to refuse to make an exception in favor of children to the general no-duty-to-trespassers rule.[9] Others required that the infant be lured onto defendant's property by the injury-producing condition without appreciation of the danger.[10] The vast majority of jurisdictions,[11] however, have adopted the *Stout* position, substantially as formulated in the *Restatement of Torts*.[12] Under that formulation, the infant trespasser[13] may recover if four conditions are met: (1) the landowner must have actual or constructive knowledge of the existence on his land of a condition dangerous to children;[14] (2) it must appear probable that children will be exposed to the condition; (3) the danger must be such that children are not likely to appreciate and avoid it;[15] and (4) the utility of the condition must be slight when balanced

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6. 2 HARPER & JAMES, *op. cit. supra* note 3, § 27.3; PROSSER, *op. cit. supra* note 3, § 76.

7. James, *Tort Liability of Occupiers of Land: Duties Owed to Trespassers*, 63 YALE L.J. 144, 161 (1953).

8. 84 U.S. 657 (1873).

9. Daniels v. New York & N.E.R.R., 154 Mass. 349, 28 N.E. 283 (1891) (turntable); Friedman v. Snare & Triest Co., 71 N.J.L. 605, 61 Atl. 401 (Ct. Err. & App. 1905) (falling girder); Walsh v. Fitchburg R.R., 145 N.Y. 301, 39 N.E. 1068 (1895) (turntable). Several states still retain the no-duty rule. See cases cited PROSSER, *op. cit. supra* note 3, at 439.

10. United Zinc & Chem. Co. v. Britt, 258 U.S. 268 (1921) (abandoned cellar); Barrett v. Southern Pac. Co., 91 Cal. 296, 27 Pac. 666 (1891) (turntable). This theory, known as the "attractive nuisance" doctrine, enabled the courts to consider the child as an invitee. The theory is also referred to as "turntable", "attractive agencies", "attractive instrumentalities" or "torpedo" doctrine. See cases collected in Annots., 36 A.L.R. 982 (1925), 39 A.L.R. 486 (1925), 45 A.L.R. 982 (1926), 53 A.L.R. 1344 (1928), 60 A.L.R. 1444 (1929). Many states which followed the "attractive nuisance" doctrine have since dropped the requirement that the child be "invited" onto the land by the dangerous condition and have returned to an acceptance of the *Stout* theory. James, *supra* note 7, at 164.

11. 2 HARPER & JAMES, *op. cit. supra* note 3, at 1450; PROSSER, *op. cit. supra* note 3, at 440.

12. RESTATEMENT, TORTS § 339 (1934).

13. Apparently there is no definite rule as to the age at which the rule ceases to apply. Recovery is seldom allowed where the child is over twelve. PROSSER, *op. cit. supra* note 3, at 444.

14. The condition must be a structure or some other artificial condition. RESTATEMENT, TORTS § 339 (1934). *But see* PROSSER, *op. cit. supra* note 3, at 443, where it is said that when this limitation is used it simply means that the existence of a recognizable and unreasonable risk of harm is required.

15. Liability is denied when the condition is such that children may be expected to appreciate the risk. Among the cases in which recovery has been denied are: Giddings v. Superior Oil Co., 106 Cal. App. 2d 607, 235 P.2d 843 (Dist. Ct. App. 1951) (moving machinery); Erickson v. Great No. Ry., 82 Minn. 60, 84 N.W.462 (1900) (fire); Atchison, T. & S.F.R.R. v. Powers, 206 Okla. 322, 243 P.2d 688 (1952) (body of water).

with the probability of harm,[16] which is to say that there must be a reasonable means available to the landowner of relieving the dangerous condition.[17]

The *Stout* rule grew out of the realization that in a crowded, industrialized society a higher responsibility must be required of the landowner than that of the no-duty rule which was based on the needs and experiences of a rural, agricultural economy.[18] The modern community must protect its children as well as its industry. In imposing the requirement of actual knowledge, the instant court appears concerned at the possibility of imposing on the landowner what it considers unwarranted liability. Ostensibly, the reason for the court's decision was a reluctance to make the landowner the insurer of the infant by imposing on him a duty to discover any dangerous conditions which may have been created without his knowledge.[19] The *Restatement,* however, imposes no duty of periodic inspection unless under all the circumstances such inspection would be reasonable.[20] Thus, while the owner of a few acres of timberland in Wyoming may be under no duty ever to inspect his land,[21] inspection might be required of the owner of a shed located next to a grade school and used for the storage of fireworks. A further, although unarticulated, reason for the court's refusal to consider evidence of defendant's constructive, as opposed to actual, knowledge as sufficient to permit plaintiff's case to get to the jury may be a desire to retain more control over the jury than it felt was possible if only constructive knowledge need be shown.[22] Whether such additional control is necessary is questionable. The courts retain power to direct verdicts under the *Restatement* rule whenever plaintiff fails to meet his burden of proof. Whether the rule imposed by the instant court will actually affect the results of many cases, however, is doubtful. Supposedly, plaintiff's burden of proof has been increased. But the number of cases in which there is no proof of actual knowledge would seem to be very small. The chances of neither a landowner nor his agents

16. Chicago, B. & Q.R.R. v. Krayenbuhl, 65 Neb. 889, 91 N.W. 880 (1902). See also Cahill v. E. B. & A. L. Stone Co., 153 Cal. 571, 96 Pac. 84 (1908).

17. This formulation does away with the old immunities designed to protect the landowner, permitting instead a straight negligence approach to the problem of land ownership and infant trespass.

18. See 2 HARPER & JAMES, *op. cit. supra* note 3, at 1450; Green, *Landowners' Responsibility to Children,* 27 TEXAS L. REV. 1 (1948).

19. Instant case at 526.

20. RESTATEMENT, TORTS § 339 (1934). For differing views on the landowner's duty to inspect, *compare* 2 HARPER & JAMES, *op. cit. supra* note 3, at 1459, *with* PROSSER, *op. cit. supra* note 3, at 445.

21. *Cf.* Puckett v. City of Louisville, 273 Ky. 349, 116 S.W.2d 627 (1938); Shell Petroleum Corp. v. Beers, 185 Okla. 331, 91 P.2d 777 (1938).

22. Courts which still cling to the no-duty rule claim that the new doctrine "gives the jury a free hand to express its feelings for the child out of the defendant's pocket." PROSSER, *op. cit. supra* note 3, at 439.

or servants [23] having had the opportunity to see the danger would seem slight. In addition, in many cases actual knowledge can be inferred from evidence which would be used to show constructive knowledge.[24] Thus, practically speaking, plaintiff's burden of proof may have increased but little by the action of the instant court. In the instant case, of course, the result was changed, at least temporarily. Under the particular facts of that case, adoption of the rule may have accomplished a desirable result in that it made possible a new trial for a defendant whose negligence seems somewhat questionable.[25] As applied to cases in which there is a strong possibility of injury to trespassing children from dangerous conditions which might reasonably be anticipated, however, the requirement of actual knowledge, if of any effect, seems likely to operate only to free defendants guilty of fault from liability for injuries sustained by innocent plaintiffs. If such is its effect, in these cases at least, the *Restatement* rule is preferable.

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23. See note 2 *supra.*

24. See 2 WIGMORE, EVIDENCE §§ 245, 252 (3d ed. 1940).

25. See note 1 *supra.*